Power in investor-state arbitration

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ABSTRACT

International investment has significantly increased in the recent decades. Because of the specific nature of host states and investors, power is of one of the most critical dynamics of this field. Despite its importance, power has been a neglected area of research in investment. Power is a complex, but highly essential concept, which can be conceptualised from different dimensions. In investor-state arbitration relationship, the three principal players have different forms of power: legal, economic, and political. This thesis argues that arbitrators have a crucial role in enhancing legitimacy and effectiveness of investment arbitration system. They can function this task through their legal powers. Firstly by complying with the main principles of the rule of law, including equality before the law, impartiality and independence, and procedural justice, arbitrators can secure the legitimacy of investment arbitration system. Secondly by balancing power inequalities and conflict of interests of the parties, on the basis of the principles of inequality of bargaining power and proportionality, arbitrators can contribute in increasing the effectiveness of the system. Thus the legitimacy and effectiveness of the investment arbitration system is contingent to power dynamic. The effect of legitimacy is to maintain sustainability, and the impact of effectiveness is to secure the development of the system. Thus power in investment arbitration, as the focus of this thesis, has a fundamental role on sustainability and development of investment arbitration as well as international investment system as a whole. Consequently power as a latent, but essential factor in investment arbitration, shall be scrutinised.

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Acronyms and Abbreviations

American Arbitration Association	AAA
Arbitration Centre of Iran Chamber	ACIC
Bilateral Investment Treaty	BIT
Energy Charter Treaty	ECT
Fair and Equitable Treatment	FET
Foreign Direct Investment	FDI
German Institute of Arbitrators	DIS
Hong Kong International Arbitration Centre	HKIAC
International Bar Association	IBA
International Centre for Dispute Resolution	ICDR
International Centre for Settlement of Investment Disputes	ICSID
International Chamber of Commerce	ICC
International Court of Justice	ICJ
International Institute for Sustainable Development	IISD
International Investment Agreements	IIAs
Iranian Foreign Investment Promotion and Protection Act	FIPPA
Iran-US Claims Tribunal	IUSCT
London Court of International Arbitration	LCIA
Multilateral Investment Guarantee Agency	MIGA
Multinational Companies	MNCs
Multinational Enterprises	MNEs
New International Economic Order	NIEO
Non-Governmental Organizations	NGOs

North American Free Trade Agreement	NAFTA
Organization for Economic Co-operation and Development	OECD
Portfolio Investment	PI
Singapore International Arbitration Centre	SIAC
Stockholm Chamber of Commerce	SCC
The Investment Policy Framework for Sustainable Development	IPFSD
The Japan Commercial Arbitration Association	JCAA
United Nation Conference on Trade and Development	UNCTAD
United Nations	UN
United Nations Convention on International Trade Law	UNCITRAL
World Trade Organisation	WTO

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INTRODUCTION

"Power should be a check to power"

(Montesquieu, Spirit of Laws, p. 161 (Book XI, s. 4))

The exponential increase in international investment in the recent decades has been accompanied by inevitable outcomes. The rise of conflicts, conflict resolution, particularly arbitration, and critical analysis of this field, as a relatively new area of international law, are some of the effects of the growth of international investment.

The specific nature of investment parties distinguishes international investment law from both international commercial law – which is concerned with private actors – and public international law – which deals with the inter-state issues. The private investors – mainly Multinational Enterprises (MNEs) – as paradigms of private actors, with economic power and pursuing private interests on the one hand, and host states (or state entities), as embodiments of public actors with political power and pursuing public interests on the other hand, represent the main parties in this field.[1] Therefore the importance of the study of international investment law as a separate field of international law is based largely on the characteristic nature of the main parties involved in foreign investment, their powers and the different interests pursued by them.

Given the potentially conflicting nature of the interests pursued by host states and foreign investors, and the crucial role that power plays in this field, disputes between

[1] Conflict of interest is a potential cause of a manifest conflict (or, as it may also be called, a dispute).

investors and host states are abound. Arbitration is one of the most common means of dispute resolution in the field of international investment. Arbitrators are delegated power to perform their functions. The initial function of arbitrators is to resolve individual disputes between parties. However, arbitrators in investment disputes also play a public role by assessing the actions of host states – such as the exercise of regulatory power in the public interest – *vis-à-vis* private interests of investors – such as requirement to act on the basis of fair and equitable treatment.

The public function of investment arbitration is one of the most challenging issues in this field. This function raises obvious issues of legitimacy of the investment arbitration system, questioning what is the role and power of arbitrators in balancing public interests of host states *vis-à-vis* private interests of investors.

As stated by Professor Wälde, the role of power with respect to international investment arbitration is "a relatively new issue in international arbitration" (Wälde, 2010). Professor Wälde supports the view that investment arbitration is biased in favour of the State as it is "asymmetrical in nature in that the treaty states wield disproportionate powers vis-à-vis the private claimants" (Wälde, 2010). The opposing view is that investment arbitration, its origin and objectives, are biased in favour of investors and thus "should be replaced by a genuinely justice-oriented system of dispute resolution for it to have any credibility" (Sornarajah, 1997, p. 107).

The various opposing claims to the issue of power in investment arbitration are either pro-investor or pro-state and they consider arbitration as a means to further the respective interests of the parties. This perception about investment arbitration is itself rooted in the relationship between the parties in an investment. While some claim that sovereign states wield significant power over private investors (Wälde, 2010), other claim that the economic

power of the investors is the dominant power in the investment relationship (Sornarajah, 1997). Based on the former view, arbitration favours (the interests of) the State as the more powerful party, whereas on the basis of the latter, arbitration favours (the interests of) the investor.

In order to illustrate the exercise of political and economic power by the investment parties and the exercise of legal power by arbitrators, and to underline the exchange of political, economic, and legal powers in the practice of investment arbitration, the Argentine cases will be addressed here as a way to introduce the theme of this research. These cases will lay an empirical foundation for further theoretical analysis. In other words, the discussion of the Argentine cases will be used to problemtize investment disputes as social conflicts.

In 1980s the Argentine state undertook economic reforms, including privatization of the main industries, which led to the increase of investment in Argentina. The objective of privatization in Argentina was to overcome the 1980s economic crisis, under which the state had faced with fiscal problems in financing investments and subsidizing the main industries, including transport and gas industries, and consequently decided to privatize the state owned industries. The competitive market and high rate of payoff attracted the investors to invest in Argentina. Thus, the policy of liberalizing and privatizing the economy underlines the exchange relationship between investors, particularly US investors, and Argentina as the host state.

The gas industry was one of the most significant sectors, which was privatized under Law No. 24.076 of 1992, or the Gas Law. This law provided specific guarantees for investors in Argentina. Put it differently, based on its political power, the Argentine state passed the Gas Law by which some rights were conferred to the investors in order to attract investment,

in exchange for the development of the country. According to the Gas Law the national gas industry of Argentina was divided into transportation and distribution industries, and were privatized. Therefore private investors, mainly from the United States, acquired shares through public tenders. For instance the CMS Gas Transmission Company, an entity incorporated in the United States, purchased 29.42% of the Transportadora de Gas del Norte (TGN). Furthermore, under the Gas Law a license determining the terms and conditions for each investor were granted by the state for generally a long term period, which was also extendable. Additionally, the Gas Law established that tariffs would be calculated in dollars, and would be adjusted every six months in accordance with the United States Producer Price Index (US PPI). The economic power of investors, including their capital and technology, made them capable to acquire shares in the gas sector and initiate investment; consequently rights and obligations were encapsulated.

A further exercise of political power of the Argentine state in pursuing the privatization policy was signing of BITs. BITs were instruments that facilitated the exchange relationship between investors and the state of Argentina. For instance, in 1991 Argentina signed a BIT with the US, the so-called 'Treaty between the United States of America and the Argentine Republic Concerning the Reciprocal Encouragement and Protection of Investment', which is one of the principal sources of the protective rights of investors in Argentina. Fair and equitable treatment, full protection and security, non-arbitrary and non-discriminatory measures, were rights conferred to investors under the US-Argentina BIT. In the BITs the power of investors were exercised indirectly through their home states. “By adhering to the BIT, Argentina traded the right to use this tool [the US-Argentina BIT] in exchange for stability of investment expectations.” (Alvarez and Khamsi, The Argentine Crisis and Foreign Investors: A Glimpse into the Heart of Investment Regime 2009, 461).

Thus Argentina and investors exercised their different powers (political and economic) in order to pursue their respective interests (public v private). In other words, the exchange relationship between investors and the Argentine state was formed by considering the rights that were conferred to the investors through the exercise of political powers of the Argentine state in the form of laws and BITs and the economic power of investors through their capital and technology; the economic power of investors was in essence the force behind the protective and other rights bestowed on them. The exchange was for Argentina to admit the investors in the country, to adopt laws providing a stable, investor-friendly regime, to sign BITs to provide legal protections under international law and for investors to actually invest their capital (money and know how) in to Argentina. The exercise of their respective powers led to the creation of rights and obligations for both parties (in the investment contract, domestic legislation and international treaties). This is the phase that the parties were in agreement, which was supposed to be stable during the investment process.

However, in early twenty first century, Argentina faced an economic crisis that affected the entire country and had severe economic as well as political consequences. In response to the economic crisis, in January 2002, Argentina passed the 'Public Emergency and Foreign Exchange System Reform Law', the so-called 'Emergency law'. The Emergency law introduced a public emergency situation and a reform in the foreign exchange system. The Emergency Law abolished the rights conferred to the investors based on the Gas Law and BITs; for instance the licences according to which the lincensees had the right to adjust tariffs according to the US PPI were terminated and the tariffs were calculated in peso instead of dollar" (*CMS v Argentina*). Accordingly, the state took a set of emergency measures, which resulted in several disputes brought by the investors before arbitration.

Put it differently, the economic crisis, pushed Argentina to again exercise its political powers to pursue the public good and adopt emergency measures. The investors claimed that

such measures are a violation of those rights and obligations that were agreed upon before the crisis (in particular Argentina's obligations under the BIT). This is the phase where disputes arose.

The gas sector cases, including *CMS, Enron, Sempra, and LG&E v. Argentina*, are paradigms of the exchange between political, economic, and legal powers. The exchange is manifested in the political power that Argentina exercised in the gas sector through the Laws and BITs, the economic powers of investors emerging from their rights, and the legal powers of arbitrators to resolve disputes between the parties.

In all the above-mentioned cases it was claimed by the investors that the rights conferred on investors on the basis of the Gas law, such as the licences, the calculation of tariffs in dollar and adjustment of tariffs every six months in accordance with the United States Producer Price Index (US PPI), were disregarded by the Emergency law. Therefore investors claimed against the state based on abuse of power by the state and breach of "legitimately acquired right" of the investors (*CMS v Argentina,* annulment). The rights of the investors were supposed to be secured on the basis of the US-Argentina Bilateral Investment Treaty (BIT), and therefore the investors' claims were predominantly violation of the BIT. The investors claims were particularly, expropriation without compensation in violation of Article IV of the US-Argentina BIT, violation of fair and equitable treatment standard based on Article II(2)(a) of the Treaty, discriminatory measures which violated Article II(2)(b) and violation of the 'umbrella clause' under Article II(2)(c) which entails that "Each Party shall observe any obligation it may have entered into with regard to investments" (US-Argentina BIT) . Overall, as asserted by the CMS tribunal "The Claimant is of the view that the measures adopted by the Argentine Government are in violation of the commitments

that the Government made to foreign investors in the offering memoranda, relevant laws and regulations and the License itself" (*CMS v Argentina,* annulment, para 84).

The response of the state to the investors' claim was that the gas sector is a national public service related to public policy. Therefore the state reserves the right to control investments in this area, and "Thus, the regulation of tariffs is a discretionary power of the Government insofar as it must take social and other public considerations into account" (*CMS v Argentina*, annulment, para 93). The Respondent further argues that the licenses did not entail "the possibility of convertibility being abandoned and that the contractual regime was therefore incomplete" (*CMS v Argentina*, annulment, para 96). Eventually it was argued by the state that all the measures were essential to restore the stabilisation of economic and political situations and preserving public services. Therefore Argentina justified its emergency measures by recourse to Article XI of the US-Argentina BIT.[2]

With respect to the arbitral tribunals' decisions, almost all four arbitral panels found that the investors had the protective rights and "stabilization" guarantees, and these had been violated by the Argentine measures (Alvarez and Khamsi, The Argentine Crisis and Foreign Investors: A Glimpse into the Heart of Investment Regime 2009). However, the way the tribunals have approached their decisions and their justifications are different. The critical issue in the arbitral decisions revolves around the importance of the public interests of the Argentine state in the eyes of the arbitral tribunals, and the balance of public and private interests of the parties. Some tribunals, such as LG&E, the annulment committees of CMS and Sempra, as opposed to other tribunals, underlined the necessity of Argentina in

[2] Article XI of the US-Argentina BIT: "This Treaty shall not preclude the application by either Party of measures necessary for the maintenance of public order, the fulfilment of its obligations with respect to the maintenance or restoration of international peace or security, or the protection of its own essential security interests."

considering its public interests over the interests of the investors, and the need to strike a balance between the interests of the parties.

The inconsistency in the decisions made by arbitrators, the use of private international commercial arbitrators in resolving investment disputes with public interests, failure in recognizing the situation and needs of Argentina and its nation, and empowering private actors as opposed to the host state, are the main critiques raised against the above mentioned arbitration decisions against the Argentine State. These critiques also raise concerns with respect to the investment arbitration regime in general (Alvarez and Khamsi, The Argentine Crisis and Foreign Investors: A Glimpse into the Heart of Investment Regime 2009). As it is claimed "the decisions issued by the arbitrators in the CMS, Enron, and Sempra cases may be intensifying a political backlash against not only the *U.S.– Argentina BIT* but the entire investment regime" (Alvarez and Khamsi, The Argentine Crisis and Foreign Investors: A Glimpse into the Heart of Investment Regime 2009).

Consequently, these four cases, although being in the same filed (gas industry) with quite similar facts, and within the framework of the same treaty (US-Argentine BIT) have led to different interpretations. On the one hand, it can be claimed that the awards in the gas sector cases are paradigms of the influence of economic power; on the other hand, it might be argued that the annulment decisions in *Sempra, Enron,* and *CMS* have been influenced by the political power of the state, which entail "worries by members of these annulment committees that upholding the multi-million dollar awards initially rendered would exacerbate the backlash against the regime and even threaten its future" (Alvarez, The Public International Law Regime Governing International Investment 2011, 470).

In order to avoid inconsistent decisions by arbitral tribunals and accordingly controversial interpretations emerged from the challenge between the two views – pro-investor and pro-state – the solution provided by this research, is to highlight the role of legal power of arbitrators and to maintain the balance. The legal power, as is suggested, could be a means to strike a balance between the political power of host states and the economic power of investors.

Therefore, the aim of this study is to underline the issue of power in investor-state arbitration as a three dimensional exchange relationship between players with three forms of power. It will be argued that investment arbitration is an exchange of economic, political, and legal powers. Thus power plays a significant role in investment arbitration. This research seeks to emphasise the fundamental role of power with regard to the challenges and problems of the system and suggests that the solution to most of the problems might be in adopting a clearer theoretical analysis.

The theoretical framework used in this research is exchange approach. The relationship between investors, states, and arbitrators is an exchange of different forms of powers – economic, political and legal powers. Exchange theoretical framework will interconnect the central concepts and ideas of the thesis together. Therefore by framing investment arbitration through the exchange theory research seeks to better address the current challenges of investment arbitration, which are those challenges related to legitimacy and effectiveness of investment arbitration regime, and whether arbitrators can balance the interests of the parties.

The reason for adopting an interdisciplinary rather than pure doctrinal method lies firstly in the scarcity of theoretical studies in the field of investment law. Secondly along with filling the theoretical gaps in this area, this thesis intends to explore the roots of the current challenges. As has been stated “A number of disputed issues in international investment

arbitration, which are presented at the surface as merely technical problems, may in reality, it is argued, be products of these deeper underlying theoretical uncertainties" (Mills, 2011, p. 1). To put it another way, the objective is to broaden the field of the study and provide a wider perspective in order to deal with the challenging issues.

The importance and originality of this research lie firstly in the fact that in the analysis of investment arbitration, it emphasises the importance of power as an extra-legal factor that entails political and economic along with legal elements. Secondly, this study assumes that the investment arbitration is a three-dimensional network of power, and thus underlines the power and role of arbitrators in this network. It establishes that every player possesses different forms of power; nonetheless they each represent a particular form of power as their dominant power. Therefore unlike the literature that examines power in investment arbitration merely as a two-dimensional network between investors and host states, this study adds arbitrators, as players who independently possess powers, to this exchange relationship. Eventually, it suggests that the power of arbitrators, as the third pillar of investment arbitration, can have a significant role in enhancing the legitimacy and effectiveness of the investment arbitration and international investment system as a whole. Therefore it considers power as a building block upon which the legitimacy and effectiveness concerns are founded.

To explore the aforementioned argument, the ideas are structured as follows:

Chapter 1 investigates the theoretical framework under which the key concepts of the thesis are connected. The aim of this chapter is to frame the exchange theory through which the scope of the fundamental terms, their notion in general and in respect to the theme of this thesis will be delineated. Power, conflict, legitimacy, authority, rationality, justice, and the actors – investors, states, and arbitrators – are the core concepts explored in this chapter.

Chapter 2 deals with the exchange relationship between investors and host states and the role of power in the pre-arbitration phase. Although the objective is to focus on the investment arbitration, in order to understand the arbitration phase, it is essential to provide an analysis of the roots of the power of the parties. For this purpose the powers of the parties from the formation of the investment relationship until the resolution of conflicts by arbitration will be examined in this chapter. Therefore, this chapter is divided into two parts exploring two pre-arbitration phases: bargaining and performance. In the bargaining phase the parties exercise their political and economic powers in order to gain legal power. In the performance of arbitration phase, the parties will exercise their legal powers in order to attain their interests, and, due to the conflict of interest between the parties – private interests of the investors on one hand and public interests of states on the other – they may misuse[3] their powers and therefore an actual conflict in the sense of legal dispute might arise. Thus in Chapter 2, the economic and political powers of the parties in the bargaining phase are identified in the first part of the chapter. Furthermore this part discusses the concept of bargaining, bargaining power, and assessment of it. The second part of the chapter, which is concerned with the performance of investment phase, identifies the legal powers of the parties. Additionally it investigates the reason for which the investment parties might misuse their legal power, which is the conflict of interests between the private and public interests of the parties.

Chapter 3 explores the exchange relationship and the role of power in the arbitration phase. In this phase the powers of the three players interact. The aim of the chapter is to investigate the role that arbitrators can play with respect to the powers of the parties when a dispute is referred to them. The chapter is devided into three parts.

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[3] It is worth noting that misuse of power in the field of investment and as used in this thesis, is different from misuse in the context of corruption, which is the exercise of public power for private interests.

The first part, identifies the legal powers of arbitrators. In this part, it will be noted that arbitrators, along with the conflicting parties, possess power. Their powers are in the form of judicial. Identifying the legal powers of arbitrators helps to show the role that arbitrators can play with their powers with respect to the powers of the parties.

The second part of the chapter is allocated to the analysis of the role of arbitrators in respect to the substantive aspect of conflicts. It examines the roles of arbitrators in dealing with the powers of the investment parties in the bargaining and performance phases. To put it another way, when a dispute is referred to arbitration and has its roots in the formation of investment agreement phase, there might be some misuse of power due to the inequality of bargaining power. The doctrine of inequality of bargaining power justifies the exercise of the legal power by arbitrators to deal with the imbalance of power. Furthermore the dispute might be rooted in the performance phase of investment. In that case power might be involved in the conflict. The doctrine of proportionality is suggested as a proper framework that justifies the exercise of power by the arbitrators to deal with the issue of power in the performance of investment phase.

The third part of the chapter concerns the procedural role of arbitrators in conflict resolution. This part will argue that investment arbitrators should function according to three principles of the rule of law: equality before the law, impartiality and independence, and procedural justice. The reasoning for such a requirement is to enhance the legitimacy of investment arbitration. After highlighting the role of power in the interaction between the players, the thesis will explore the importance of the legal powers of arbitrators in balancing power inequalities and the interests of the conflicting parties. The importance lies in its impact on the legitimacy and effectiveness of investment arbitration and the international investment system as a whole. Accordingly, the rule of law, legitimacy and effectiveness are examined in the fourth chapter under the title of the power and the law.

Chapter 4 elucidates the idea that arbitration (the legal power) must rule and should not be a means for the powerful parties to exert their power over the weaker ones. Furthermore it develops the idea that the rule of law leads to the legitimacy and effectiveness of arbitration. It concludes that legitimacy essentially results in the stability of an investment arbitration system. Furthermore the thesis continues by arguing that effectiveness, another pillar of the rule of law, ensures the development of the investment arbitration system in the dispute resolution system and amongst other forms of dispute resolution mechanisms.

Finally, the **Conclusion** will draw together the ideas discussed and explored in the research. Furthermore, some implications and recommendations for future research will be suggested in order to fill the gaps and supplement the nascent field of international investment law.

CHAPTER 1 THEORETICAL FRAMEWORK: AN EXCHANGE APPROACH

The aim of this chapter is to develop a coherent and overarching theoretical framework that links the central concepts and ideas of the thesis together, which will then be applied in a uniform manner throughout the thesis to the study of state/investor arbitration.

Amongst a vide range of theories, exchange theory, as "one of the most prominent and productive branches of sociological theorizing" (Turner 1998, 263), is believed to be the approach best suited for the purpose of this thesis, which is to examine the relationship between political, economic, and legal powers of the players in investor/state arbitration. First and foremost, exchange theory is about the relationship of rational actors that exchange their resources, and it correlates with the subject of investment which is the exchange of resources.

Additionally exchange theory is a broad framework that entails major and interrelated concepts such as power, legitimacy, authority, conflict, rationality, inequality, imbalance, justice, and fairness(Cook and Rice, Exchange and Power 2002). The named central topics of exchange theory are the core dynamics of the thesis.

Furthermore, exchange theory is a strong theory, which "includes within a single theoretical framework propositions that apply to individual actors as well as to the macro level (or systemic level) and it attempts to formulate exlicitly the consequences of changes at one level for other levels of analysis"(Cook, O'Brien and Kollock 1990, 175). Thus, it can be applied to various levels of analysis: individuals, corporations, and nation-states (Ritzer 2011); which makes it possible to apply the theory to the study of the relationship between investors, states, and arbitrators.

As Emerson, one of the leading developers of exchange approach, postulates "[exchange theorical approach] is a frame of reference within which many theories – some micro and some more macro – can speak to one another, whether in argument or in mutual support"(Emerson, Social Exchange Theory 1976, 336).

To further support the reasoning behind choosing exchange theory as the relevant theoretical framework for the present study, it is worth quoting Dezaly and Garth that "Arbitration is a place of exchange." (Dezalay and Garth 1996, 124). Put it differently, apart from their own relationship, investors and states enter into an exchange relationship with arbitrators after a dispute emerges. Thus, although in different stages, investors and states, and then investors and states with arbitrators form exchange relationships.

Therefore exchange approach will be used as the theoretical framework in this thesis. To apply this to the current research it is essential to further elaborate exchange theory. Thus the history and origin of the theory is explained at the outset. Principal developers of exchange theory and their contributions to this theory are discussed in this section. Each of these developers introduce propositions which help understanding this theoretical framework. Therefore in section B, main principles of exchange theory will be examined. These principles entail some dynamics that constitute the core concepts of the thesis; power, conflict, justice, legitimacy, rationality, and the actors – the state, investor, and arbitrator – will be explored in section C. In the final section of the chapter concluding remarks are discussed.

A. History of Exchange Theory

The initial traces of exchange theoretic ideas are rooted in the assumptions of free market and Adam Smith's notion of supply and demand, which has been then translated from economics into sociology (Turner 1998). The proposition revolves around the fact that rational actors seek to maximze their benefits in exchange relationships and transactions with others in a free market. As actors have limited resources, they need to exchange their own resources with other actors equipped with alternative resources in order to gain benefit.

However, exchange theory as a distinct theoretical approach, particularly in the field of sociology, emerges in the 1960s by its principal developers George C. Homans, Peter M. Blau, and Richard M. Emerson(Cook and Rice, Exchange and Power 2002). Each of these theorists explore exchange theory by emphasizing on specific perspectives.

Homans's exchange theory has a behaviouristic orientation with basis in psychology. Put another way "[h]e attempted to explain social behavior with psychological principles" (Ritzer 2011, 420). Homans' emphasis is on the exchange of rewards and costs, and the value of an action: the valuability of an action increases the probability of rewarding that action, the more that person's action is rewarded the more that person performs that action, and the more the action of the person is similar to an action rewarded in the past, the more that action is to be performed in the future (Turner 1998). Homas adds psychological elements to his theory by introducing aggression and approval propositions: depending on the compatibility of expected rewards with the actually received rewards, the reaction of persons differ from anger to satisfaction. Homans' focus is on interpersonal relationship(Cook and Rice, Exchange and Power 2002). Due to the nature of the current study – as a topic related to corporations and states – psychological concerns are of least importance. Therefore, the

contribution of the two other developers of exchange theory – Blau and Emerson – will now be examined.

Blau argues that his theory "is rooted in the peculiarly social nature of exchange, which implies that it cannot be reduced to or derived from psychological principles that govern the motives of individuals, as Homans aims to do" (Blau, Exchange and Power in Social Life 1986, ix). Blau's theory is a general framework that is capable to analyse mirco as well as macrostructures. Therefore, exchange between individuals and collectivities can be studied under his theoretical framework. Furthermore Blau explored major dynamics of an exchange relationship. Power, conflict, legitimization, justice, rationality are the main dynamics that Blau examined through sets of principles and propositions governing an exchange relationship. Analysis of the above-mentioned dynamics and principles within a theoretical framework, as the principal objective of this chapter, is a sufficiently important topic to deserve a section on its own right and it will be dealt with after a brief analysis of Emerson's exchange approach.

Emerson's attemp was to integrate Homans' psychological orientation and emphasis on the role of individual actors (Emerson, Exchange Theory, Part I: A Psychological Basis for Social Exchange 1972a), with Blau's micro-macro structural approach and focus on individuals as well as collective organizations(Emerson, Exchange Theory, Part II: Exchange Relations and Networks 1972b); the result was the emergence of exchange network approach (Emerson, Exchange Theory, Part II: Exchange Relations and Networks 1972b). "The use of the notion, exchange network, allows for the development of theory that bridges the conceptual gap between isolated individuals or dyads and larger aggregated or collections of individuals (e.g., formal groups or associations, organizations, neighborhoods, political parties, etc.)" (K. S. Cook, Emerson’s Contributions to Social Exchange Theory 1987, 219).

A further aspect of Emerson's theory is his emphasis on the central role of power in exchange relationship. Put it differently, "Emerson was intersted in exchange theory as a broader framework for his earlier interest in power dependence"(Ritzer 2011, 431). Power, dependence, and imbalance are building blocks of Emerson's exchange theoretical framework.

Apart from Homans, Blau, and Emerson, other scholars in the different fields of social science have contributed in the development of exchange theory. In the remaining parts of this chapter the principles and dynamics of exchange approach, as an integration of different perspectives of the main developers of the theory, in a way which is applicable to the exchange relationship between the actors of this thesis – investors, states, and arbitrators – will be introduced.

B. Principles of Exchange Theory

Theoretical frameworks are formed of a number of propositions. Based on their viewpoint and theoretical background, the developers of exchange theory have introduced various principles. These principles, particularly those of the main developers of exchange theory, have to be fully explored. The principles introduced by Homans are *success, stimulus, value, deprivation/satiation, agression/approval, and rationality principle*. According to the first principle, the more an action is rewared the more that action is likely to be repeated. The stimilus principle specifies that an action that has been rewarded in the past is more likely to be performed in the future. Based on the value principle, the more valuable an action, the more likely that action is to be performed. Deprivation/satiation or as is also called the marginal utility principle, denotes that the more a particular reward has been given to an action, the less valuable is that rewarded action. In other words, some rewards become less effective over time (Cook and Rice, Exchange and Power 2002). Agression/approval principle is a more psychological principle which denotes that actors react by anger and aggression when their reward is not what they expect. Conversely, those actors who receive expected rewards or more than what they expect, will be pleased with the outcome. Eventualy, for the rationality principle, Homans asserts that if the value of an action is high, though the probability of getting it is low, and if the value of another action is lower, but the probability of getting it is higher that the first action, then humans as rational actors, would emit the second action – the less valued but more probable action.

As mentioned earlier, Homans' propositions of exchange approach have psychological nature. Blau's propositions, on the other hand, are more sociological in nature. The key principles of Blau's exchange approach are *Rationality principle, Reciprocity principle, Justice principle, Marginal Utility principle, and Imbalance principle* (Turner 1998).

The *rationality principle* denotes that the actors enter into a relationship in order to gain profits. The more they attain profits from an exchange relationship, the more it is likely they enter in a relationship and maintain it. For instance a sale contract is based on mutual profit and benefit. The more profit they gain from selling and buying, the more they conclude and continue their contractual relationship. Blau calls this motivation – which leads the actors to enter into social exchange relationships – *social attraction*. No rational actor would engage in an exchange relationship without a social attraction or incentive. This is similar to what Homans calls as stimulus proposition.

The social attraction, which is the benefit that actors expect from a relationship, is reciprocated by the costs that they incur in conferring benefits to the other party, and is called the *reciprocity principle.* "The more people have exchanged rewards with one another, the more likely are reciprocal obligations to emerge and guide subsequent exchanges among these people" (Turner 1998, 272).

From the network structure perspective, there are two forms of exchange: reciprocal and negotiated. “In negotiated exchange, actors engage in a joint decision process, such as explicit bargaining, in which they seek agreement on the terms of exchange”(Molm, Peterson and Takahashi 2003, 130). In contrast, in reciprocal exchanges actors do not enter into bargaining; “Rather, in reciprocal exchanges, an actor provides benefits for the other without knowing in advance if, or how much, the other party will provide in return” (Turner 1998, 332).

Economic exchanges are generally paradigms of negotiated exchange under which the actors bilaterally negotiate and thus exchange their benefits and resources. "Social exchange in contrast [to economic exchange] involved the principle that one person does another favor,

and while there is a general expectation of some future return, its exact nature is definitely not stipulated in advance" (Blau, 1986, p. 93).

Benefits and costs should be exchanged on a fair basis. This leads to the third principle: *justice.* This principle determines the proportion of benefits to costs in an exchange relationship.[4]

Based on the *marginal utility principle* the frequent emission of a reward for a particular action will reduce its value and effectiveness. This principle assimilates to the deprivation/satiation principle.

Finally the *imbalance principle* addresses the idea that "the balance and stabilization of one exchange relation is likely to create imbalance and strain in other necessary exchange relations" (Turner 1998, 272).

Thus Blau emphasised on propositions that entail the rational actors in exchange relationships. In his view, rational actors seek to maximize their utilities, and therefore enter into relationships in order to exchange what each possesses. He further argued that some might possess less resource than the other actors, and therefore may be dominated. This domination/subordination situation leads to inequality in exchange relationships. "It is the emergence of such relations of subordination and domination and their self-perpetuating character that Blau believed was the basis for power inequality" (Cook and Rice, Exchange and Power 2002, 702). Therefore, Blau pointed the underlying concepts in exchange theory, such as rationality, justice, legitimacy, and particularly power and inequality.

[4] Justice as one the main dynamics of exchange relationships and in the field of investment will be examined in detail in section III of this chapter.

Emerson, further highlights the concept of power in his theory of exchange. He builds the propositions of this theory on the basis of *power*, *dependency*, and *balancing*: the more an actor (*A*) is dependent on the other (*B*), the greater is the power of *B* over *A,* and the more imbalanced is that relationship; furthermore, the more imbalanced an exchange relationship is, the more likely it is to become balanced at a later stage of time(Turner 1998).

Ivan Nye integrated the propositions of Homans, Blau, Emerson, and other developers of exchange theory and came up with the following theoretical propositions:

1. "Individuals choose those alternatives from which they expect the most profit.
2. Cost being equal, they choose alternatives from which they anticipate the greatest rewards.
3. Rewards being equal, they choose alternatives from which they anticipate the fewest costs.
4. Immediate outcomes being equal, they choose those alternatives that promise better long- term outcomes.
5. Long-term outcomes being perceived as equal, they choose alternatives providing better immediate outcomes.
6. Costs and other rewards being equal, individuals choose the alternatives that supply or can be expected to supply the most social approval (or those that promise the least social disapproval).
7. Costs and other rewards being equal, individuals choose statuses and relationships that provide the most autonomy.
8. Other rewards and costs equal, individuals choose alternatives characterized by the least ambiguity in terms of expected future events and outcomes.
9. Other costs and rewards equal, they choose alternatives that offer the most security for them.
10. Other rewards and costs equal, they choose to associate with, marry, and form other relationships with those whose values and opinions generally are in agreement with their own and reject or avoid those with whom they chronically disagree.
11. Other rewards and costs equal, they are more likely to associate with, marry, and form other relationships with their equals, than those above or below them. (Equality here is viewed as the sum of abilities, performances, characteristics, and statuses that determine one's desirability in the social marketplace.)

12. In industrial societies, other costs and rewards equal, individuals choose alternatives that promise the greatest financial gains for the least financial expenditures." (Nye 1982) (McDonell, et al. 2012).

To comprehend what the structure of exchange relationship and its aforementioned principles is, presuposes insight into the notion of the constituting elements and dynamics of these principles. Put another way, a series of dynamics underpin the exchange relationship that can be derived from the principles of exchange theory. These dynamics have essential role on the process and result of exchange relationship. The most important and relevant dynamics to the study of investor-state arbitration relationship also central to the exchange theory are power, conflict, legitimacy, authority, rationality and justice. The following section will delineate the notion and the conceptual thread that relates these concepts within an exchange approach.

C. Dynamics of Exchange Theory

I. Power

Power is the central focus of exchange theory, as is also in this thesis. Power is present in every social structure. The three dimensional relationship between investors, states and arbitrators as a social structure and as the core of this study is not exempt. Therefore it is essential to investigate the notion of power. However, the aim here is not to explore the concept of power in a systematic and generic manner. The primary reason for this is the extensive literature on this theme that exists in various fields of social science including sociology, philosophy, and political science. The problematic issue is not only the sizeable number of theories of power, but also the complexity, contestability and overlapping arguments between these theories. Scholars in different fields of social studies provide diverse definitions of power. Some of these definitions are in contradiction; some overlap with others, and some have no relation, each discussing power from a specific perspective. Accordingly, although some scholars are considered to be influenced by and followers of their precedents, even in a single school of thought there is no consensus on the notion of power; this fact renders a unified classification of theories perplexing. This is because social and political theorists "are not writing about power in general but using power as a local conceptual tool within a specific language game" (Hauggard 2002, 3). A further problem in the conceptualisation of power is that there is no agreement among scholars what a definition of power should define: power as an abstract issue, exercising power, or having power (White 1972). These conceptual problems have led Steven Lukes to argue that, although being pervasive and essential to social relations, "power is an essentially contested concept" (Lukes, 2005, p. 30).

i. Definition of Power

The term 'power' is used in a bewildering variety of ways in the literature and it will be defined here with regard to the contextual background of this thesis. As is argued by Lukes, "Power is one of those concepts which is incredibly value-dependent" (Lukes, 2005, p. 30). Put another way, its definition varies depending on the context and the use of it. This part seeks to explore power in a way that is appropriate to investment arbitration, and as the objective of this thesis is to investigate the role of power in this specific field, it is beyond the context of this study to present an extended and systematic analysis of the notion of power. Power in this thesis is conceptualised in terms and within the framework of exchange approach. Therefore, the language game of exchange shall be used to explore the notion of power in this specific field.

In the field of exchange theory, power is defined in terms of dependency and balancing. Put it differently, as examined earlier, Emerson's principles of exchange relationships are based on three main dynamics: power, dependency, and balancing(Emerson, Power-Dependence Relations 1962). The three factors are interlinked. First of all the exchange relations are formed of mutual dependency. Secondly, power plays a critical role in such an exchange relation; "power is an attribute of position in a network structure observable in the occupant's behavior, even though the occupant does not know what position or what amount of power s/he possesses" (Cook & Emerson, 1978, p. 721). Eventually, as for imbalance dynamic it is worth noting that "The notion of reciprocity in power-dependency relations raises the question of equality or inequality of power in the relation" (Emerson, Power-Dependence Relations 1962, 33). The definition of power, which is analysed by Emerson under the dependency approach – which is part of exchange approach and is also called power-dependency – entails the three aforementioned elements and provides a theoretical

model for measuring power in an exchange relationship and in light of the interaction of these elements.

Although initially actors enter into an exchange relationship on an equal level, the value and availability of resources to actors affect the dependence of an actor on the other. The dependence of one actor over the other is in fact his *power* over the other. Emerson represents power in exchange relationships with an equation of $P_{ab}=D_{ba}$ $P_{ba}=D_{ab}$; meaning that the power (P) of *a* over *b* is equivalent to the dependency (D) of *b* over *a* (Emerson, 1962). In cases where $P_{ab}= P_{ba,}$ power is balanced. However in cases where $P_{ab}>P_{ba}$ or $P_{ab}<P_{ba}$, power is unbalanced, or to put it another way, domination exists.

Resource value and *resource availability* are two principal indicators in assessing the degree of dependency and power of an actor over the other (Emerson, 1962). The more the value of A's resources and the less those resources are available to B, the more dependent B is to A and the more powerful is A. The value of resources that each party provides is assessed by the need of the other party for those resources.

Moreover, availability is an important element that affects power. If different actors provide the resources, the party that needs those resources (B) is able to secure the resources from alternative suppliers, and the power of A decreases. Therefore competition among suppliers of resources significantly affects the power of actors in an exchange network. The more the competition among resource providers and thus the more resources are available by alternative sources, the lower is the degree of dependence on a particular actor. On the other hand, unilateral monopoly of A gives him extensive power over B.

The dependence factor is the most crucial variable in determining the amount of power at different stages, from preliminary negotiations and bargaining to resolution of conflicts. It

is worth emphasising that a minimal degree of mutual dependency is necessary for the formation of a contractual relationship. It is the mutual benefit and profit and interdependence of both contracting parties that attracts them to enter into exchange relationships. However, not all cases are based on minimal and equal mutual dependence. The degree of dependency of the parties is essential in determining their power. The more one party is dependent on the other the less is its power in comparison to the other party. Consequently the more powerful party can get more advantageous terms as a result of its power over the dependent party. The less powerful party may consent to less advantageous and even onerous terms due to its excessive dependence on the resources available to the other party. The terms of a contract, thus, may not be merely based on fair and equal bargaining. So far as unequal power is concerned, the contract cannot be regarded as an exclusive reflection of free will and justice.

"Power-dependence theory asserts that all power relations are either balanced or imbalanced" (Thye, 2000, p. 410). In symmetrical relationships the situations of the parties are balanced and there is a relative equilibrium between the parties. In asymmetrical relationships there are imbalances between the conflicting parties. Generally, exchange relationships are – or ought to be – balanced. Balanced relations between parties are based on mutual dependence, which denotes "giving each *absolute power* over the other and, thereby, increasing *structural cohesion* because of the high amounts of *total* or *average power* in the exchange relationship" (Turner 1998, 318). Cohesion is a variable in the exchange relationship that determines the persistence of the relationship against conflicts, which is also related to dependency of actors. The more the actors are dependent on each other the more is the cohesion of their relationship. (Cook, Cheshire, & Gerbasi, 2006), and thus the lower is the risk of being destroyed by conflict. The reason is the mutual dependence and the need of

the actors in the exchange relationship. Cohesion is greater in symmetrical relations with balanced powers.

“Unequal dependencies produce an imbalanced relation in which the less dependent actor has a structural power advantage” (Molm, Power, trust, and fairness, 33). Balanced power is when the dependency of actors is equal. “Inequalities can result from exchange because some actors possess more socially valuable resources than others do.” Which may lead to subordination, “It is the emergence of such relations of subordination and domination and their self-perpetuating character that Blau believed was the basis for power inequality” (Cook and Rice, Exchange and Power 2002, 702).

The relationship between power, imbalance and dependency can be summarized in the words of Cook and Rice, "A power inequality results from an imbalance in power relations between two or more actors. An exchange relation is balanced if both parties are equally dependent on each other for exchange (or resources of value). If they are equally dependent, they have equal power. The central idea that power is based on dependence allows for the specification of ways in which dependencies can be altered to affect the balance of power in the exchange relation and in the network of connected exchange relations." (Cook and Rice, Exchange and Power 2002, 705).

ii. Typology of Power

Typology of power will be discussed in two types: formal and substantive. The 'formal typology' subsection, below, investigates the forms and structures of power. Power may be manifested in the forms of force, coercion, manipulation, inducement, authority, and expertise. Along with these forms, power can be latent or observable.

The second subsection develops the typology of power from a 'substantive' aspect. Disregarding the form of exerting power, the type of power can vary depending on the status and sources of the power holder. For instance, a political position holds sources of political power and thus possesses political power; an agent that holds economic status, possesses economic resources and consequently has economic power; a legal agent is equipped with legal resources and therefore has legal power. It is worth noting that some types of power may predominate in a particular relationship, although other forms of power might be present in that relationship (Boulding 1990).

This section will first explore the formal typology of power. The conceptions of force, coercion, manipulation, inducement, authority and expertise as the most pertinent forms of power are therefore examined. Then this section proceeds to types of power from a substantive perspective. Consistent with the actors, their positions and the resources that they possess, three substantive forms of power will be investigated: political, economic and legal power.

a. Formal Typology

The typology of power is examined from different standpoints, by emphasising different criteria. Nonetheless most of the classifications of forms of power are correlated

and overlap with others and can be integrated. Galbraith presents one of the general typologies of power. According to Galbraith's anatomy of power, there are three forms of power: *condign, compensatory, and conditioned* (Galbraith 1983). "Condign power wins submission by the ability to impose an alternative to the preferences of the individual or group that is sufficiently unpleasant or painful so that these preferences are abandoned" (Galbraith 1983, 22). This form of power has a negative connotation and equates it to punishment. Physical punishment, torture, fines and the threat of expropriation are examples of condign power.

Compensatory power, in contrast, "offers the individual a reward or payment sufficiently advantageous or agreeable so that he (or she) forgoes pursuit of his own preference to seek the reward instead" (Galbraith 1983, 30). Compensatory power has an affirmative sense of rewarding with offering benefit. Condign and compensatory powers are two forms of power that are observable and are exerted consciously, the powerful and the powerless are aware of the exercise of power.

Conditioned power is defined by Galbraith as a type of power, which is exerted by forming beliefs. "Persuasion, education, or the social commitment to what seems natural, proper, or right causes the individual to submit to the will of another or of others"(Galbraith 1983, 23). As opposed to condign and compensatory power, conditioned power is latent and is exercised over the powerless without their awareness of the exercise of power, by shaping their beliefs and interests. The use of power in the conditioned form is more common in the modern era and in economic and political fields, although condign and compensatory powers exist and are exercised to a lesser degree.

Scott provides a typology similar to, but more developed than Galbraith's. In his typology, Scott is particularly inspired by Machiavelli's characterisation of different forms of power. Scott classifies forms of power as *corrective* and *persuasive*.

"Corrective influence operates through the use of resources that can serve as punitive and remunerative sanctions that are able to work directly on the interests of subalterns in power relations" (Scott 2001, 13). Force as a negative concept, manipulation as both a positive and negative notion, coercion as a developed form of force and inducement as a developed form of manipulation are samples of corrective power. Force and coercion can be equated to condign power; manipulation and inducement can be compared to compensatory power discussed by Galbraith.

Persuasive power "operates through the offering and acceptance of reasons for acting in one way rather than another" (Scott 2001, 13). Authority and expertise are two forms of persuasive power. This type of power is similar to the conditioned power of Galbraith.

In this respect it is worth comparing Lukes' typology of power which rests on his conceptualisation of power as conflict of interests. He classifies coercion and force as two types of power in situations of observable conflict of interests and manipulation as a form of power in cases of latent conflict. Lukes excludes consensual conferment of power from the scope of power. He argues that "...influence and authority may or may not be a form of power – depending on whether a conflict of interest is involved. Consensual authority, with no conflict of interests, is not, therefore, a form of power" (Lukes, 2005, p. 35). Furthermore, according to Lukes' model of power, inducement, encouragement, persuasion and similar terms that entail no conflict of interest are not forms of power.

Integrating the aforementioned typology models, a typology pertinent to the theme of investment arbitration will be designed. According to this integrated model, force and

coercion are corrective and observable (overt), manipulation and inducement are corrective and latent, authority is persuasive and observable, and expertise is a persuasive and latent form of power (See Table 1). In order to discover which players possess which type of power(s), it is worth elucidating the notion of every type briefly.

Force is generally perceived as the use of physical social action; however psychic force that affects the emotions and not the body is also a type of force (Wrong 1995). Force is mainly a negative sanction (Scott 2001). "Force is more effective in preventing or restricting people from acting than in causing them to act in a given way" (Wrong 1995, 27). Force is either violent or non-violent. Some scholars do not consider violent force as a form of power. Arendt believes that power and violence are in opposition and violence is used when there is no power(Arendt 1970). The military power of the state is the typical paradigm of force. Force is interwoven with the threat to use force, which is conceptualised as coercion.

Coercion is a moderate form of force; it implies the presence of pressure and threat from one party against the other and in fact it is the threat to exercise force with the belief of the powerless that the powerful has the ability and willingness to use force. Coercion affects the free will; it constraints the volition or inhibits it (Wertheimer 1987).

It is believed that "there are two main types of social power: coercive and non-coercive. The latter type of power is authority, because if *A* influences the behaviour of *B* through his relevant authority *A* need not present any threat. And *B* will still yield" (Airaksinen 1984, 109). Thus, according to this perception, the difference between coercion and authority is the presence of threat in the notion of coercive power. According to Machiavelli's mythical characterisation of the forms of power, coercion – as well as force – is assumed as the power of lions that hold and exercise power directly and oppressively.

Manipulation is "When the power holder conceals his intent from the power subject – that is, the intended effect he wishes to produce, he is attempting to manipulate the latter" (Wrong 1995, 28). In most of the cases the complier of manipulation may be unconscious about the exact intention of the powerful party and the exercise of manipulation over him. Advertisements by actors with economic power, such as large companies, and political propaganda of states are examples of manipulation (Scott 2001).

Inducement is an advanced form of manipulation and is in effect manipulation through the offering of rewards in order to persuade the subject to act in a certain way (Scott 2001). Inducement is commonly used with the intention to intrigue and exploit the weaker. Lukes does not classify inducement as a type of power, as inducement does not consist of conflict of interest – neither observable nor latent. Arendt considers the developed forms of corrective powers – coercion and inducement – as negative power and describes them as violence (Arendt 1970). In Machiavelli's characterisation of types of power, manipulation and inducement are categorised as the power of foxes, which are defined as those who exert power by deceit.

Authority: Command is the advanced form of persuasive power and is based on "the *right* to give orders and a corresponding *obligation* to obey" (Scott 2001, 20). The reason for the powerless to obey is the willingness to comply with the legitimate orders. "This legitimacy flows from the internationalisation of significant cultural meanings and an identification with those who are seen as their guardians or guarantors because of the positions that they occupy through election, appointment, or some other accepted procedure"(Scott 2001, 20). This type of power can be equated with the concept of authority. Thus, legitimacy, authority, and power are intertwined. "Legitimacy, therefore, is a quality possessed by an authority, a law, or an institution that leads others to feel obligated to obey

its decisions and directives" (Tyler, procedural justice, legitimacy, and the rle of law, 308). Authority is the legitimised form of power. “Legitimacy converts power into authority and makes compliance with the directives of dominating actors obligatory” (Johnson 2004, 9). Therefore the concept of legitimacy is correlated with the concept of authority, which is itself a form of power, and thus legitimacy is interlinked with power. In other words, “legitimacy is necessary in almost all situations of authority” (Tyler, 2003, p. 308).

“Authority exists whenever one, several, or many people explicitly or tacitly permit someone else to make decisions for them for some category of acts” ((Lindblom, 1977, p. 17-18) cited in (Scott, 2001, p. 20)). Thus regarding the topic of this thesis, authority – particularly authority in the sense of performing an action – is related to the role of arbitrator. The disputing parties confer authority on the arbitrator in order to resolve their conflicts.

Weber defines authority as legitimate domination and classifies it into *legal authority, traditional authority,* and *charismatic authority* (Weber 1978). “Authority will be called traditional if legitimacy is claimed for it and believed by virtue of the sanctity of age-old rules and power” (Weber 1978, 226) and charismatic authority is “applied to a certain quality of an individual personality by virtue of which he is considered extraordinary and treated as endowed with supernatural, superhuman, or at least specifically exceptional powers or qualities” (Weber 1978, 241). Although the two latter forms of authority are important, they are not directly related to the present subject. Legal authority, on the other hand, is fundamental to examining the power of arbitrators. Weber defines legal authority as “...the legality of enacted rules and the right of those elevated to authority under such rules to issue commands” (Weber 1978, 215).

Weber mentions some points as essential elements of legal authority. Two of the elements are relevant to the authority of arbitrators and their relations with the disputing

parties. The first factor is in respect to the person in authority – here the arbitrator – and the other is in regard to those who obey commands – the conflicting parties. "... [T]he typical person in authority, the "superior", is himself subject to an impersonal order by orienting his actions to it in his own dispositions and commands"; "The person who obeys authority does so, as it is usually stated, only in his capacity as a "member" of the organisation and what he obeys is only "the law"" (Weber 1978, 217).

Moreover, it is worth mentioning that those who obey an authority obey that authority for his impersonal order as he has competence to rule and do not obey the individual and personal order of the authority. In other words the obedience of subordinates is limited to impersonal, legal jurisdiction of the authority (Weber 1978). Machiavelli's characterisation of power classifies authority as the power of the bear.

Expertise is an advanced form of power (Scott 2001); it is the power of knowledge and skills. The skills and specialised knowledge of the expert attract the confidence of the dominated and therefore secures compliance (Scott 2001). An expert is a person with deep and specialised knowledge in a specific field. In modern times, the value of expertise as a type of power has increased and knowledge is replacing traditional physical work. An expert's knowledge of a subject is a source of power with economic value. Knowledge and power are intertwined; knowledge creates power and power generates knowledge (Foucault, 1980). "The expert, for his or her part, may try to ensure that their technical knowledge remains an esoteric monopoly, seeking to avoid the possibility that subalterns may challenge them. This may involve combining expertise with manipulation" (Scott 2001, 23). Experts can control and monopolise the field of their expertise and those who are in need of those experts. Possessing monopolistic expertise puts experts in a powerful position and they try to exploit, dominate, close and secure those specialised domains from potential competitors (Reed 1996). The less is the monopoly of the experts and the more is the competition, the less

is the centrality of the experts' power. Therefore there is a close link between expertise, scarcity of that expertise, and power. Based on Machiavelli's mythical classification of power, expertise is considered as the power of the owl.

Considering the definitions of different formal types of power, it could be claimed that force and coercion are typical powers of the state; nonetheless the state may also exercise power in the form of manipulation and inducement. Investors' economic power provides them with the ability to manipulate or induce the host states to enter into investment. Furthermore they possess power in the form of expertise, due to their knowledge, know-how and technology in the specific field of investment. Authority is the power of arbitrators; however they also have power in the form of expertise, due to their knowledge of the law and resolution of conflicts. Thus, the formal typology of power can be shown diametrically as in Table 1.

Table 1: Formal Typology of Power

TYPOLOGY OF POWER	***OBSERVABLE***	***LATENT***
CORRECTIVE	*LION* FORCE COERCION	*FOX* MANIPULATION INDUCEMENT
PERSUASIVE	*BEAR* AUTHORITY	*OWL* EXPERTISE

b. Substantive Typology

As opposed to formal power, which entails the structural form of power, substantive power encompasses the content of it, which is itself determined by the centres of power and sources available to them. Generally power is embodied in institutions which are "*power centres*" (Poulantzas, 1973, p. 115). The power centres in respect to the present context are the state, investor and arbitrator. The state is "*the centre of the exercise of political power*" (Poulantzas, 1973, p. 115), investor is the centre of the exercise of economic power, and arbitrator is the centre of the exercise of legal power. Thus, with regards to the relationship between investors, states, and arbitrators, substantive forms of power can be classified based on powers that they predominantly possess; therefore political, economic, and legal powers are considered as three substantive types of power. These three substantive types of power will now be delineated briefly.

Political Power

The state is the manifestation of political power and as is claimed "Political power means *state* power" (M. Mann 1993, 9). However this does not mean that the only power of the state is political. Like their functions, states possess diverse forms of power; nonetheless the political power of states is their predominant power.

Weber conceptualises the term 'political' as follows: "A "ruling organisation" will be called "political" insofar as its existence and order is continuously safeguarded within a given *territorial* area by the threat and application of physical force on the part of the administrative staff" (Weber 1978, 54). According to Weber's definition, three main factors can be highlighted. Firstly political power is territorial, secondly it is exercised by coercion and force and thirdly it is exerted by the state. The first factor needs to be analysed in the modern

time specifically in relation to foreign investment. The more modern concept of the state regarding its mechanisms of power is based on its power within its territory towards the nation as well as *outside* the territory in relation to other states and transnational entities.

Political power is the ability to arrange governmental affairs. The most severe form of political power is military power, which is the exerting of power in the form of force. Notwithstanding political power can be in the form of coercion or even latent through manipulation and inducement.

Political power guarantees the existence of different systems as well as other forms of the powers of the systems, including economic and legal systems, by its legitimate power via different means with various degrees, such as influence, legislative authority, coercion and even military power. Political power of the state in this sense is when the state is functioning its apparatus role as a political actor to create order and to maintain order in society. As mentioned previously in section (I) on 'the state', in investment relationships, the state is supposed to function as an economic party equal with investors.

Economic Power

Every type of power has some subjects that possess and exert that form of power. Therefore each type of power consists of a system with some units. The power of the units within each system differs. Accordingly, an economic system is constituted of economic actors. These economic actors range from individuals to large companies and thus their power varies. The power of an individual merchant in a developing country is not equal to the power of an MNE that is based in a developed country and acts in multiple countries. The value and degree of the power of economic actors are contingent on the sources they possess. The economic sources vary, and consistent with this variation the powers of economic actors

also differ. Money, property, wealth, natural resources, industrial output, agricultural output, technology, and know-how are all sources of economic power.

The holders of different sources of economic power use them to dominate different fields and actors. For instance "[t]he business leaders economize on jurisprudence by investing in lobbying or in doctrinal consultation. Working through professor-lawyers as intermediaries, they are able to exert pressure to influence the interpretation of norms – even to obtain their redefinition – to conform more to their interests"(Dezalay and Garth 1996, 208).

In an investment relationship, although both the state and the investors possess economic power, their power varies depending on the type of sources they possess as well as the availability of those sources. The differential in the type of resources "determines to what extent various contractual partners are actually free when they dispose of their resources in their mutual traffics" (Poggi, 2001, p. 141).

An excessive economic power engenders other forms of power; additionally, possessing different forms of power amplifies the power. It is believed that "The economic system has an intrinsic tendency (ignored by the main-line economic theory) to generate a power structure within itself. It has also an intrinsic tendency to extend its reach more and more widely over society at large" (Poggi, 2001, p. 136). In this respect, Marx went further and believed that economic power is the ruling class. Therefore within an economic system, those actors with more power can dominate and by virtue of their excessive economic power can gain other forms of power, such as political and legal power.

Legal Power

Legal power, in regard to this thesis, can be defined as *the rights that are stipulated in legal documents such as a contract, treaty, convention, or regulation*. Power and rights are two intertwined concepts that overlap in some respects and are different from other aspects. "A legal power is usually defined as the legal ability to change a legal relation; such powers are usually spoken of as rights" (Jones 1994, 22).

According to Hohfeld's classification of rights, power is a form of rights (Hohfeld 1917). Hohfeld categorises legal rights into four types: claims, liberties, powers and immunities. In Hohfeldian term, legal rights are defined by correlatives. Claims are correlative to duties, liberties are correlative to no-right, and immunities are correlative to disability. The correlative of power – as a type of rights – is liability in other parties; "this meaning that the latter are subject, *nolens volens*, to the changes of jural relations involved in the exercise of A's powers" (Hohfeld 1917, 746). Thus whenever one party has a legal right in the sense of power the other party has a liability to abide by that legal right (See Table 2).

From a power dynamic perspective, it can be stated that one type of power originates right. Rights confer power to the rights holders in order to reach their interests; thus they can be referred to as legal power. For instance the rights of the investors to fair and equitable treatment confer them power against the host state and therefore can be considered as legal power. Legal powers are those powers that are based on rights of the power holder.

Table 2: Hohfeld's Correlativity Axiom

Right (Claim-Right)	Privilege	**Power**	Immunity
Duty	No-Right	**Liability**	Disability

II. Conflict

One of the cucial aspects of exchange approach is the inequality of resources possessed by the actors and the potential conflict that might arise in the exchange relationship between these actors with unequal resources. The actors with more valued resources have power over those with less valued and more available resources. This underlying proposition of exchange theory which entails the unequal distribution of resources and thus emergence of conflict, is the core of Marx's conflict theory. It is worth emphasising that "sociological theories of exchange converge with those on conflict processes, and Marx's and Weber's ideas exerted considerable influence on sociologically oriented exchange theories"(Turner 1998, 258). As postulated by Turner "Dilectical conflict theory is a variety of exchange theory"(Turner 1998, 259). Therefore the concept of conflict is a common field in conflict and exchange approaches. In this respect Blau has introduced the conflict principle in the framework of exchange theory under which "the more actors in a social exchange manipulate the situation in an effort to misrepresent their needs for a resource or conceal the availability of resources, the greater is the level of tension in that exchange and the greater is the potential for conflict" (Turner 1998, 260). Thus, the concept of conflict, as a principal dynamic of exchange approach as well as a crucial element of investor-state arbitration, merits deep examination.

At the outset, before venturing to the analysis of the concept of conflict, it is worth noting the difference between the term conflict and dispute. These two terms are sometimes used interchangeably; nonetheless the two terms tend to be different. In commercial and investment fields generally the term dispute is used to conceptualise any disagreement between the parties. However in this thesis the term conflict is used instead of dispute. The reasoning for this paradigm shift is the difference in the nature of the two terms. Dispute concerns legal issues whereas conflict is a broader concept that entails social, economic and

political factors along with legal elements (Menkel-Meadow 2004). The term conflict takes into consideration legal as well as extra-legal influences over the process of the disagreement from formation to resolution and therefore provides an ample analysis of the case.

As investment is a product of multidimensional interactions between two players from different backgrounds and with different characteristics – investors with an economic nature and states with a political nature – thus the concept of dispute may not sufficiently reveal the underlying issues that affect the emergence and resolution of the controversies in this realm. Conflict as an umbrella term can aptly describe different aspects of legal, economic, political and social influences. Furthermore in order to find an appropriate means to deal with investment disputes, it might be necessary to investigate socio-economic-legal factors; therefore it is conducive to use the term conflict.

Conflict, like power, is the product of interactions and cannot be envisaged in abstract terms. The more interaction, the higher is the risk of the emergence of conflict. As international investment increases, so too does the risk of conflict between investors and states. In other words, conflict is inevitable in the relationship between investors and states. Therefore it is essential to comprehend the nature of conflict in order to find optimum mechanisms to deal with them.

There are complex interpretations of what exactly the term ‘conflict’ entails. Some have defined conflict as “a situation in which actors use conflict action against each other to attain incompatible goals and/or to express their hostility” (Bartos and Wehr 2002, 27). A different view on the notion of conflict is based on the link between conflict and power. Accordingly conflict is defined as the struggle for balancing power (Rummel 1976). Conflict arises from the clash of one power against an opposing power; thus conflict is the struggle between the opposing powers in order to balance the powers; and when the powers are

balanced the conflict ends. Weber: definition of conflict is consistent with the latter definition. In the words of Weber "A social relationship will be referred to as "conflict" (*Kampf)* insofar as action is oriented intentionally to carrying out the actor's own will against the resistance of the other party or parties" (Weber 1978, 38).

Considering the aforementioned definitions of conflict, it can be perceived that conflict is complicatedly multifaceted. Each definition defines conflict from a specific approach and none is incorrect. For instance the first definition(Bartos and Wehr 2002) focuses on the causes of conflict; and the last two definitions are emphatic on the correlation between power and conflict, and define it as a process.

In order to develop the nature of conflict and provide a pertinent definition consistent with the theme of this study, the initial step is to determine its characteristics. The second step is to explore foreign investment conflicts based on the general characteristics of conflict.

i. Characteristics of Conflict

Characteristics of conflict entail an analysis of the elements, causes, types, and phases of conflict. Conflict is formed of a set of interrelated ***elements***: "parties, issues, dynamics and contexts" (Bartos and Wehr 2002). In identifying the concept of conflict it should be remarked that conflict arises between at least two *parties* (host states and investors); it is over specific *issues,* some *dynamics* affect it (the most crucial being the power of the conflicting parties); and it is within a specific *context* (foreign investment). Thus, on the basis of its elements, an investment conflict can be defined as any struggle between investors and the state over specific issues – depending on the circumstances of the case – which is affected by different dynamics, most importantly power, and is in regard to investment.

Conflict, – consisting of different elements, – ensues on the basis of various ***causes***. "Identifying the operative causes in any single conflict helps us both to understand that conflict and to deal with it" (Bartos and Wehr 2002, 9). Therefore it is important to illustrate the causes of conflict.

Myriad causes for the emergence of conflict may be explored: incompatibility of goals, competition for scarce resources, recognition of rule of violation – rules that define how people ought to act toward one another and define their relationships (Lulofs and Cahn 2000), and hostility (Bartos and Wehr 2002). These causes have some overlap and can be classified in a cluster of ways. Synthesising the classifications on the causes of conflict it can be discerned that conflict may be caused by two general causes of *incompatible goals or violation of rules.*

'Incompatible goals' is a broad conception that entails three factors: contested resources, incompatible roles, and incompatible values (Bartos and Wehr 2002). What some authors call 'contested resources'(Bartos and Wehr 2002) and others call 'competition for scarce resources'(Lulofs and Cahn 2000) are equivalent and connote struggle for resources in order to gain more power.

Incompatible roles are divided into horizontal and vertical. In vertical roles there is hierarchy in the positions; for instance a judge or an arbitrator is in a higher position to command and resolve disputes between the conflicting parties. On the other hand, the relationship between the disputing parties is a horizontal one. The horizontal roles are supposed to cooperate in order to achieve a common purpose (Bartos and Wehr 2002).
Incompatible values as the third type of incompatible goals, is also known as the incompatibility of personal dispositions and values such as hostility. Hostility is a dispositional behaviour that can be rational or non-rational; in other words a person or group

may be hostile towards another with or without any reason and cause. There is a correlation between hostility and conflict: "On the one hand, hostility adds fuel to and intensifies conflict behaviour. On the other hand, conflict also intensifies hostility: as conflict continues and the parties inflict injuries on each other, the participants are no longer motivated solely by a desire to reach their original goals; increasingly, they become determined to destroy the enemy"(Bartos and Wehr 2002).

Finally a conflict may be caused by the *'violation of rules'*. The parties, the law or a third party may set these rules. In most legal disputes, including investment disputes, the violation of rules is considered as the main cause of dispute; breach of contract by one party establishes a cause and base for a dispute and a claim on behalf of the other party. In investment relationships violation of minimum standards of treatment by the host states is generally the base of disputes. Nonetheless other causes can lead to and have a significant effect on the emergence of an actual conflict.

On the basis of the three main causes of conflict, conflict can be categorised into three general ***types***: behavioural conflicts which are those conflicts caused by competition over resources and incompatible goals, i.e. over issues that are observable and tangible; normative conflicts which are conflicts that have emerged through the violation of rules; and value-based conflicts which are conflicts caused by personal likes and dislikes(Lulofs and Cahn 2000).

Furthermore conflict is a cycle consisting of ***phases***; it arises, it is dealt with and eventually it is resolved (Lulofs and Cahn 2000). The simplest theory on the phases of conflict implies that conflict starts with differences and ends with integration of preferences by resolving the dispute (Walton 1987).

According to a more comprehensive classification of phases of conflict there are five stages (Rummel 1976). The first phase is when the conflict is latent; which is when there are potentialities for the emergence of conflict. The second phase is the initiation phase when the conflict starts to arise and manifests. The third phase is called the balancing of power; it is when the opposing powers struggle and is in fact the actual conflict between powers. The fourth stage is the balance of power when the conflict is resolved and powers are balanced. Eventually the last phase is the disruption stage, when the cycle of conflict renews and a new conflict ensues.

A further similar model of conflict process is to categorise phases of a conflict into four stages: prelude to conflict, initiation, differentiation and resolution(Lulofs and Cahn 2000). The first phase in the conflict process is the *prelude* stage. One of the determinant factors in the prelude stage is the relationship of the disputants who have unequal power. The questions in this phase are in regard to the power of the conflicting parties: "Are the participants in a hierarchical or equal relationship? How well do they know each other, both in breadth and depth of knowledge? Does one tend to dominate the other? How have they done conflict in the past?"(Lulofs and Cahn 2000, 88). In this phase the conflict is latent and not yet manifest. This phase is equivalent to Rummel's latent conflict phase (or the potential or conflict space phase).

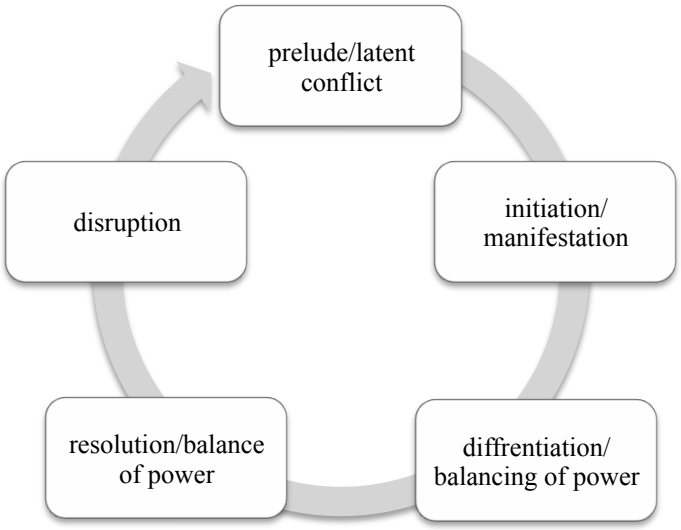
The following phase is the *initiation* phase; it is when the latent conflict is manifested and the conflicting parties realise the presence of a conflict. In this stage the conflicting parties have to decide to confront or avoid the conflict. If the conflicting parties opt for the latter alternative then conflict enters into the third phase: *differentiation*. In the differentiation stage the conflicting parties decide to confront their differences rather than avoid them. This stage is equivalent to the balancing stage of Rummel's classification.

The final phase is the *resolution*[5] stage. Resolution is a specification of conflict that differentiates conflict from other relevant terms such as competition. In other words in a very broad sense, conflict covers different kinds of incompatible behaviour; however, the peculiarity that limits the scope of conflict and distinguishes it from other relevant – though different – concepts such as competition and simple disagreements is the requirement of 'resolution'(Lulofs and Cahn 2000). Moreover, the resolution stage is one of the most important phases of conflict that has a direct effect on the function of conflict. The initial purpose and function of conflict is to be positive and productive. "Productive conflict is characterised by flexibility, belief that all can achieve important goals, and balance between competitiveness and cooperation."(Lulofs and Cahn 2000, 16). Conversely, when conflicts are mismanaged in a way that do not satisfy the parties they are dysfunctional; "When participants in the conflict lose sight of their original goals, when hostility becomes the norm, when conflict becomes a regular part of the interaction between people, it is destructive"(Lulofs and Cahn 2000, 14). The balance of power stage in Rummel's phases of conflict is equivalent the resolution phase (see Figure 1).

Effectiveness of conflict resolution is one of the incentives for the parties – both investors and the host state – in entering into commitment and can secure the success of investment in general. Conversely, ineffective conflict resolution escalates the cost and time by recourse to alternative methods; it diminishes the security and increases the risk of investment (Franck S. D., 2007). Thus an appropriate means of conflict resolution will have a positive effect on future conflicts as well as the investment industry as a whole. Thereby conflict and conflict resolution are crucial topics that merit further consideration. Conflict in the field of foreign investment will be analysed based on the above-mentioned definitions.

[5] This thesis intends to investigate only the last phase of conflict – 'resolution' – and only one mechanism of conflict resolution – 'arbitration'.

Figure 1: The Conflict Cycle



ii. Foreign Investment Conflict

Considering definitions and characteristics of conflict in general, *foreign investment conflict* can be defined as any disagreement that emerges between investors and the state or state entities over specific issues in relation to investment, that can be caused by incompatibility of goals, and/or violation of the rules, can be affected by different dynamics, particularly power of the parties, and can be resolved by conflict resolution mechanisms – mainly arbitration.

Incompatibility of goals can cause conflict between investors and host states. For instance when it is according to the interests of the host state to amend the taxation law and the new law is disadvantageous to the investors, the two parties have incompatible goals that can lead to a conflict. Hostility can also be a cause of conflict in investment relationships. A typical example of conflict caused by hostility is the hostility between the host state and the

home state of the investor. As a consequence of the relationship between the host state and the home state, the host state may alter its policy and maltreat investors of the hostile state.

Notwithstanding, investment conflicts are largely caused by violation of the rules and by disregarding one of the parties' legal rights. For instance a host state violates investors' protection rules, such as equal treatment, by treating another investor better and this can be a cause of conflict. Generally, foreign investment conflicts caused by the violation of rules can be classified into two categories based on the origin that they emerge from. According to this classification, foreign investment conflicts are either conflicts emerging from violation of treaties (BITs)[6] or conflicts that arise from violation and breach of investment contracts.

Not all BITs are performed properly. During the performance of an investment, terms and conditions of the BIT may be breached and therefore lead to claims by the damaged party. By way of illustration these claims may be "physical expropriation of farmland by the government without prompt, adequate and effective compensation; violation of fair and equitable treatment for a lack of transparency in regulations governing an investor's loan; and

[6] "An investment treaty is an agreement made between two or more governments that safeguards investments made in the territory of other signatory countries" (Franck S. D., Empirically Evaluating Claims About Investment Treaty Arbitration, 2007-2008, p. 8). Therefore, two states (in Bilateral Investment Treaties) or more (in Multilateral Investment Treaties) by signing a treaty, provide investors rights and protections in the host state. "These rights might include guarantees of appropriate compensation for expropriation, promises of freedom from unreasonable or discriminatory measures, guarantees of national treatment for the investment, assurances of fair and equitable treatment, promises that investments will receive full protection and security, undertakings that a sovereign will honour its obligations, and assurances that foreign investment will receive treatment no less favourable than that accorded under international law" (Franck S. D., Empirically Evaluating Claims About Investment Treaty Arbitration, 2007-2008, p. 9).
Moreover, "Bilateral investment treaties offer foreign investors a series of economic rights, including the right to arbitrate claims, in hopes of attracting foreign direct investment (FDI) that will bring a country infrastructure projects, financing, know-how, new jobs and economic stability." (Franck S. D., Foreign Direct Investment, Investment Treaty Arbitration and the Rule of Law, 2007, p. 338).

discriminatory treatment based on the government's failure to stop looting of the claimant's property by the military" (Nolan and Baldwin 2006, 1). Furthermore, foreign investment disputes based on treaties "may also involve more subtle government conduct, such as (1) revocation of a banking license (2) change in the interpretation of tax law that decreases an anticipated refund (3) passage of an environmental regulation that has a disparate and adverse financial impact upon foreign investors (4) failure to advise an investor about licenses needed to operate an investment or (5) alleged breach of a commercial contract to which the government is a party" (Franck S. D., 2007-2008, p. 10). However, not all investment conflicts are treaty-based; some may arise as a result of breach of contract.

Generally, in every kind of exchange relationship, there is a balance between the rights and obligations of the parties; ascendancy of one over the other may cause conflicts. A foreign investment contract is not exempted; there is a balance between the host states' and investors' interests. A host state is mainly interested in fiscal resources and foreign exchange earnings, infrastructure development, acquisition of technology, managerial know-how and labour training, downstream integration, effect on the economy, attracting further investment and increasing income; while investors' interests entail control over marketing conditions, maintaining a stable flow of products and competing in the market place (Wolfgang 1995). When one of the parties acts to the detriment of the rights and interests of the other party, a conflict may arise. Therefore, from the contractual perspective "a foreign investment dispute is one between an investor from one country and a government that is not its own that relates to an investment in the host country" and is concerned with the claim of breach of the investment contracts between them (Bishop, Crawford and Reisman 2005, 5).

As considered above, theoretically there is a clear line between contract-based and treaty-based foreign investment conflicts. Contract-based foreign investment conflicts are

conflicts based on violation of the investment contracts between investors and host states, whereas treaty-based foreign investment conflicts are alleged breaches of the BITs.

However, in practice, determining the difference between contractual and treaty-based foreign investment claims is not as straightforward as theory suggests, and the boundaries between the two types of conflict are blurred. In practice, arbitral tribunals are particularly concerned with the problem of identifying the original nature of investment conflicts especially in order to determine their jurisdiction over the dispute. There are situations in which contract-based foreign investment disputes fall within the jurisdiction of treaty-based disputes. One of these situations is where the breach of foreign investment leads to the breach of international law, for instance when the violation of an investment contract violates the principle of fair and equitable treatment.

In some BITs, dispute settlement clauses are drafted extremely broadly and encompass different types of investment conflict. By way of example, in *Vivendi v. Argentina* (*Vivendi II*) the conflict resolution clause declares: "Any disputes relating to investments made under this Agreement between one Contracting Party and an investor of the other Contracting Party." (*Compañiá de Aguas del Aconquija S.A. and Vivendi Universal v. Argentine Republic* (*Vivendi II*), 2002). Principally, '*any disputes relating to investment*' entails contract-based as well as treaty-based conflicts. Nevertheless, not all tribunals have the same point of view or interpretation about broad dispute settlement clauses in BITs (Reinisch, 2006-2007).

The most controversial issue with regard to contract-based and treaty-based foreign investment disputes derives from the fact that "many investment treaties include clauses by which a state agrees that it will observe obligations or commitments it has entered into with investors, sometimes referred to as umbrella clauses"(Nolan and Baldwin 2006, 3). The reasoning behind naming these clauses as umbrella clauses is "because they put contractual

commitments under the BIT's protective umbrella" (Schreuer, 2004). Umbrella clauses are also referred to as *pacta sunt servanda* clauses, mirror effect clauses, observation of commitments clauses, observance of undertakings clauses, and sanctity of contract clauses (Reinisch, 2006-2007, p. 5).

The objective of umbrella clauses "is to create an inter-state obligation to observe investment agreements that investors may enforce when the BIT confers a direct right of recourse to arbitration" (Wong 2006, 145). An example of an umbrella clause is Article 10(1) of the Energy Charter Treaty, which states: "Each Contracting Party shall observe any obligations it has entered into with an Investor or an Investment of an Investor of any other Contracting Party."

According to the provisions of BITs' umbrella clauses, it is evident that these clauses include treaty-based foreign investment disputes. However, the controversial question is whether these clauses cover contract-based investment conflicts as well. Interpretations of umbrella clauses have been diverse and sometimes opposite in different cases involving these types of clauses. As an example, two cases of various interpretations and therefore different results from umbrella clauses are *SGS Société Générale de Surveillance, S.A. v. Pakistan* and *SGS Société Générale de Surveillance, S.A. v. the Republic of the Philippines.*

In the *SGS Société Générale de Surveillance, S.A. v. Pakistan* case, the tribunal held that "The text itself of Article 11 does not purport to state that breaches of contract allege by an investor in relation to a contract it has concluded with a state (widely considered to be a matter of municipal rather than international law) are automatically 'elevated' to the level of breaches of international treaty law" (*SGS Société Générale de Surveillance, S.A. v. Pakistan*, 2003, para. 166).

Conversely, the arbitral tribunal in *SGS Société Générale de Surveillance, S.A. v. the Republic of the Philippines* held "To summarise the Tribunal's conclusions on this point, Article X(2) makes it a breach of the BIT for the host state to fail to observe binding commitments, including contractual commitments, which it has assumed with regard to specific investments. But it does not convert the issue of the extent of content of such obligations into an issue of international law" (*SGS Société Générale de Surveillance, S.A. v. the Republic of the Philippines*, 2004, para. 128).

Therefore, according to the latter case, contractual claims do not fall within the jurisdiction of BITs' umbrella clauses, whereas according to the former case, observance of obligation which is determined in BITs' umbrella clauses by the home and host states, should be read as the obligation of state to observe all the contractual terms of the foreign investment contract between the investor and the host state and thus, breach of contract claims can constitute treaty-based investment conflicts.

To support the latter opinion it has been said that "the history of the umbrella clause makes clear that it was designed to allow for any breach of a relevant investment contract to be resolved under the treaty in an international forum" (Wong 2006, 145). Furthermore, "although the decisions above do not all reach the same conclusion on the interpretation of the 'umbrella clause' – due in part to the different language included in the treaties under examination – it seems that there is a growing consistency on the interpretation of its meaning to include 'all obligations' by the state, both treaty and contractual" (Yannaca-Small 2006, 40).

Consequently, conflict is an inevitable aspect of exchange relationships. It is caused by several factors, and is managed and controlled by resolution mechanisms. Furthermore there are dynamics that affect the formation and resolution of conflict. Power is one of the most

crucial dynamics of conflict. As discussed previously, a pivotal cause of conflict on which conflict theory is based is the inequality of power. Moreover conflict is defined as struggle for balancing power (Rummel 1976). Thus conflict and power are two intertwined concepts. Power is omnipresent; it is present in all the phases of conflict and is therefore central in understanding arbitration outcomes.

The correlation between conflict and power is generally discussed in different theories with regard to the emergence of conflict. The relation of conflict and power in the resolution phase has been less discussed by conflict and power theories. Therefore the role of power in the process of balancing and resolution of conflict merits further investigation. “The use of power is necessary to move a conflict to productive management.”(Lulofs and Cahn 2000, 141). Thus power is constantly used in conflict resolution; the only issue is to “choose the type of power to use and whether to use it in productive or destructive ways”(Lulofs and Cahn 2000, 141).

III. Justice

"In any situation in which benefits are exchanged or distributed, questions of justice arise" (Molm, Peterson and Takahashi 2003). Justice is at the centre of exchange theory; it has been broadly analysed and linked to the dynamics within the framework of exchange, particularly power (Cook and Emerson, Power, Equity, and Commitment in Exchange Networks 1978) (Blau, Exchange and Power in Social Life 1964) (Homans 1961).

Conceptions of justice are classified in different forms. Distributive justice and procedural justice are two types of justice mostly emphasied in the exchange framework (Cook and Hegtvedt, Distributive Justice, Equity, and Equality 1983, 219).

"Distributive justice denotes the norms or rules by which the allocation of resources among actors occurs" (Turner 1998, 321). Equality, equity, and need are the principal rules determining the allocation of resources (Cook, Hegtvedt, Distributive Justice, Equity, and Equality) (Turner 1998). *Equality* is the allocation of equal shares to all the actors in an exchange relationship, disregarding their contribution in the relationship. The *equity* rule, or as is also called the principle of 'relative equality' (Eckhoff 1974) is "the distribution of resources reletive to the respective inputs and contributions of actors to an outcome" (Turner 1998, 322). Finally, the *need* based rule concerns the distribution of resources regarding the requirement and need of the actors in the exchange relationship(Cook and Hegtvedt, Distributive Justice, Equity, and Equality 1983) (Turner 1998).

Procedural justice denotes that "judgments of fairness are a function not only of outcomes in relation to some standard but of the process or procedures through which those outcomes are obtained" (Molm, Peterson and Takahashi 2003, 129). Put it differently, procedural justice refers to the process of bargaining and negotiation disregarding the

outcome. "Fair procedures enhance perceptions that outcomes are also fair, enhance satisfaction with the relation, create more positive attitudes toward authorities, and produce favorable effects on a variety of behavioral reactions, from task performance to dispute resolution" (Molm, Peterson and Takahashi 2003, 132).

The link between distributive and procedural justice is blurred. Generally when outcome is fair, there is no objection of the procedure, even if the procedure is unfair; on the other hand, when the outcome is unfair, procedures are perceived to be unfair too, even if the procedure is fair (Cook and Hegtvedt, Distributive Justice, Equity, and Equality 1983).

Justice is interwoven with the concept of power. The more advantaged party often perceives the distribution of resources as fair, whereas the less advantaged assumes that the situation is unfair and they tend to bargain to balance the relationship (Turner 1998) (Hegtvedt, Thompson and Cook 1993). The link between these two conceptions are best described as follows:

"If power use generates a sense of justice, or if it is used in accordance with accepted norms of distributive and procedural justice, then power use will produce more balanced exchanges. If power imbalance leads to actions by the advantaged actor that violate rules of justice, or if behaviors generate a perception of injustice, then power use will perpetuate imbalance, and disadvantaged actors will seek new strategies to rebalance the exchange, if they can" (Turner 1998, 322).

In rebalancing the exchange, the role of an authority, as a neutral third party is essential. Three factors are considered to be important for the authority in respect to procedural justice: "the neutrality of the decision-making procedure (i.e., the degree to which procedures are applied consistently across group members), the actor's trust in the authority

(assessment of the authority's motives as benevolent), and information conveyed about the actor's standing or status in the group by the authority's treatment of the actor" (Molm, Peterson and Takahashi 2003, 132). Therefore, as authorities have major impact on the procedural justice in an exchange relationship, authority is correlated with the concept of justice. Furthermore, authority is correlated with legitimacy. Besides, perception of procedural justice affects the legitimacy of a system, and as is asserted "Legitimacy is a central concept in procedural justice theory" (Hough, et al. 2010). Therefore it is essential to explore the concept of legitimacy within the framework of exchange theory.

IV. Legitimacy

The origin of the conceptual analysis of legitimacy is rooted in Weber's literature on authority. Weber's conception of legitimacy, as one of the most prominent theories of legitimacy – which is considered by the developers of exchange theory and thus will be applied to this study – is a mixture of consensus and conflict theory (Walker & Zelditch, 1993); his definition is neither based entirely on consent nor is it fully originated from conflict theory.[7]

Legitimacy, for Weber, is a quality possessed by an authority that obliges the subordinates to obey the commands of the authority. Weber argues that obedience of commands cannot be secured by power; it is the legitimacy of the commands that ensures obedience (Weber 1978).

Based on Weber's typology of legitimation, there are three grounds for the legitimacy of authority: legal grounds, traditional grounds, and charismatic grounds.[8] The legitimacy of the legal authority rests on rationality and "a belief in the legality of enacted rules and the right of those elevated to authority under such rules to issue commands" (Weber 1978, 215).

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[7] The phenomenon of legitimacy has been explained in the light of various theories: consensus, conflict, and a combination of these theories (Zelditch, 2001). Thus the definitions of legitimacy vary extensively based on the theoretical perceptions. According to the consensus theory, legitimacy is a by-product of agreement in achieving the interest of a group as a whole (Zelditch, 2001). In other words, any action in line with the group's goals is considered as legitimate. According to the conflict theory, which is mainly a Marxist theory, "the function of legitimacy is to mask the real interests of the ruling class." (Zelditch, 2001, p. 43) Based on this theory, the interests of the powerful – in Marxist terminology the 'ruling class' – are in conflict with the interests of the subordinates; the superordinates use the concept of legitimacy in order to conceal the reality and validate their actions. Thus legitimacy in this sense is a means to further the objectives of the powerful party.

[8] The three grounds of legitimacy were discussed in the section on 'authority'.

The first part of Weber's definition of legitimacy emphasises *belief* as a quality of an institution that holds authority to govern. A system, rule or an authority depends "on the degree to which those to whom it is addressed believe themselves obligated by it" (Franck T. M., 1990, p. 44). Belief is in fact the acknowledgement and recognition of the validity of an object of legitimacy. Accordingly, it has been argued, "Legitimacy is the recognition of the right to govern" (Coicaud 2002, 10). Thus the legitimacy of investment arbitration is *the recognition and belief in the right of the arbitrators to make decisions that must be complied with by the conflicting parties.*

As for the *legality* criterion in the definition of legitimacy, Weber asserts that orientation to certain determinable maxims or rules is the key component in legitimization (Weber 1978). Accordingly, the legality of a system indicates the application of the rule of law.

According to Aristotle the foundation of legitimacy is the rule of law (Zelditch, 2001, p. 41). Thus the rule of law is regarded as one of the main sources of legitimacy; legitimacy develops out of the principles of the rule of law governing the arbitration process. The rule of law is a prerequisite for legitimacy and legitimacy is a precondition for maintenance and stability of any system.

In the conception of legitimacy discussed thus far the rule of law has not been mentioned – at least expressly – as one of the sources of legitimacy. However, concepts such as 'right process' and 'fair treatment' impliedly refer to the rule of law and its constituting principles. For instance, Thomas Franck emphasises the concept of right process in the conceptualisation of legitimacy: "Legitimate institutions, like legitimate rules, are those *which are established and function in accordance with ascertainable principles of right process*" (Franck T. M., 1990). Accordingly he defines legitimacy as "*a property of a rule or*

rule-making institution which itself exerts a pull toward compliance on those addressed normatively because those addressed believe that the rule or institution has come into being and operates in accordance with generally accepted principles of right process" (Franck T. M., 1990, p. 24).

Legitimacy is ubiquitous, but it is an auxiliary phenomenon; its effect is to increase adherence and validity or to decrease the resistance to other processes (Zelditch, 2001). Legitimacy is not an independent factor; it is a criterion to measure the validity of other social processes (Zelditch, 2001). Therefore the function of legitimacy is to act as a measure to test the validity of a system; a measure to assess whether a process such as investment arbitration is based on maxims and rules.

It is worth noting that, as Weber ascertains, one type of legitimacy – and in effect the most common one in the modern legal systems – is legal legitimacy and is based on rationality. Therfore, rationality as an interrelated concept to legitimacy as well as a dynamic of exchange theory will be examined in the following part.

V. Rationality

Rationality is one of the core dynamics of exchange theory. As examined in the principles of exchange theory, in exchange relationships actors as rational players seek to maximize their profits. It is their rational decisions that form the basis of exchange relationships.

Weber distinguishes between two types of rationalization: substantive and formal(Weber 1978). “In general terms, substantive rationalization is based on certain values and conceptions of justice, whereas formal rationalization rests on general rules and procedures” (Deflem 2008, 45).

Substantive and formal rationality lead to different consequences. "[L]aw is substantively irrational when legal decisions are influenced by the concrete factors of a case on the basis of ethical, emotional, or political considerations rather than by general rules (traditional law)"(Deflem 2008, 45); and it is formally irrational "when legal decisions are based on means which are not intellectually controllable" (Deflem 2008, 45).

As arbitration is a means of decision-making and dispute resolution, formal rationality is of relevance to its analysis. One of the results of formal rationality is decision-making based on the rules pertinent to the facts of the case; on the other hand, formal irrationality leads to upredictable decisions. Put it differently, formal rationality is based on rules and laws as opposed to decision-making on the basis of arbitrariness(Kalberg 1980). Formal rationality confers freedom on actors to calculate and predict the results of their actions; “[t]he freedom granted by formal rational law, however, remains itself also a formal matter, as inequalities that exist, for instance in terms of economic position or political rights, are not taken into account. The formal freedom legally guaranteed to all thus impedes on the actual possibilities to satisfy the values and needs of many” (Deflem 2008, 46).

VI. Actors

It is worth noting that, exchange takes place among at least two actors. Therefore actors are crucial dynamics in the theoretical analysis of exchange. Actors HAVE influential roles in the function of a system. In the study of this thesis, the principal actors of investment arbitration relationship are investors, states, and arbitrators. Although other players might function in this system, their role is not as essential as the main players. Furthermore the focus of this research is on the three-dimensional relationship between the principal players and therefore other players such as Non-Governmental Organisations (NGOs) are out of the scope and context of this thesis.

This first part begins with a section examining of the role of the state. Before venturing to an analysis of the role of the state in international investment, the concept of 'state' will be investigated according to different political theories.
A second section then proceeds to a discussion of the concept and role of investors in international business. In this respect the meaning of investment as the primary function of investors will be elucidated. Therefore the core of this section is based on the function of investors, as actors who invest in host states.

The final section of this part will explore the third pillar of investment arbitration: the arbitrator. Understanding the role of arbitrators as third party conflict resolvers in general and in respect to investment conflicts is central to the study of power in investment arbitration. In other words, the theoretical analysis of arbitrators provides a useful insight of their role, their function, and their powers. Therefore it is conducive to explore the roots of the concept of arbitration.

i. The State

The state as one party of the International Investment Agreements (IIAs) is known as the host state.[9] The host state with respect to investment conflicts is an *institution* with the economic *function* of developing its country's economic prosperity – it performs this function by entering into investment treaties with home states or investment contracts with investors – and possesses different forms of *power* with various degrees. In the field of foreign investment, host states are mainly developing countries that need investors' assistance to develop their economies. Nonetheless as the political power of the states is their predominant form of power, in some circumstances they may use it in order to redress their deficiencies in other forms of power.

The above-mentioned conceptualisation of the host state is based on an integration of different theoretical analyses of the notion of the state in general. In order to further elucidate the role of the state in investment – as an equal-level party and/or sovereign state – it is thus essential to analyse the elements of that definition.

The state is a broad, complex and controversial concept. The origin of the word 'state' is *status*, a Latin word meaning condition (D'Entreves 1967). Parallel to its literal meaning, in the ancient era the word state was equivalent to the condition of well-being and good life. In this respect Aristotle stipulates:

"Every state is a community of some kind, and every community is established with a view to some good; for mankind always act in order to obtain that which they think good. But, if all communities aim at some good, the state or political community, which is the highest of all, and which embraces all the rest, aims at good in a greater degree than any other, and at the highest good" (Aristotle, 2007).

[9] The focal concern of this research is on host states as one principal pillar of foreign investments; however it is worth mentioning that capital-exporting countries, as the home states of the investors, play a latent and indirect role in the investment process. The home state's role is mainly to negotiate investment treaties – BITs or multilateral treaties – with host states. However, the home state can support investors by diplomatic protection. Moreover investors, mainly MNEs, influence home states by their economic power and secure the home states' support in the political field through lobbying. Thus the function and influence of the home state is relatively political.

The use of the term state in its modern sense as a political concept can be traced back to Niccolo Machiavelli. Machiavelli identifies the state in terms of its main characteristics, which are organisation, territory, population, and exercise of power (force): "All states, all powers, that have held and hold rule over men have been and are either republics or principalities" (Machiavelli 1505, 81).

Contemporary theories of the state are diverse. No single definition of the state is widespread and comprehensive; though this does not mean that definitions of the state are deficient. Theories concerning the notion of the state analyse it from different standpoints and it is the wide nature of the state that necessitates these complexities. To name but a few of the classifications provided by scholars, the state can be defined as accentuating "formal institutional features, and/or the foundational instruments or mechanisms of state power" (Jessop 2010, 4); some definitions consider institutional and functional aspects of the state (M. Mann 1993); and some definitions portray the state as a government, apparatus and/or ruling class(Krasner 2009). Integrating various definitions and classifications of the state it can be concluded that the state should possess some attributes in order to be distinct from other entities. Organisation, territory, nation, bureaucracy, coercive control, sovereignty, and legitimacy – which can be described as the relation between the state and law – are all characteristics of a modern state (Poggi, 1990). Therefore on the basis of these characteristics, the state can be defined by underlining three main aspects: the institutional aspect, functional aspect, and state power.

a. The Institution of the State

One set of definitions of the state emphasises the institutional aspect including state territory, state population and state apparatus (Jessop 2010). From the institutional – or as it is also called foundational – perspective, the institution of the state is an apparatus in a specific territory governing a particular population called the nation. In the words of Jessop, "the *core of the state apparatus* can be identified as a distinct ensemble of institutions and organisations whose socially accepted function is to define and enforce collectively binding decisions on a given population in the name of their 'common interest' or 'general will'" (Jessop 2010, 9).

A further institutional definition of the state is provided by Mann:
"1.The state is a differentiated set of institutions and personnel

2. embodying centrality, in the sense that political relations radiate to and from a center, to cover a
3. territorially demarcated area over which it exercises
4. some degree of authoritative, binding rule making, backed up by some organised physical force."(M. Mann 1993, 55).

Although definitions emphasising the institutional feature of the state are comprehensive, they merely contemplate the domestic aspect of the state and do not cover the international dimension. As in the theme of this research the state is studied as a player in the international investment domain a purely domestic definition is not sufficient and cannot serve the purpose of this research. There is therefore a need for a broader definition.

b. Functions of the state

The functional feature is concerned with the duties of the state and "what the state does" (M. Mann 1993, 55). Aristotle, in The Politics, asserts that the state provides everything for the nation: "It provides all men's needs (material, social, religious, etc) and offers them the fulfilment not only of living but of living 'well', in accordance with those virtues that are peculiarly human" (Aristotle, 1992, p. 55). Consistent with the ancient beliefs, modern states are crystallised into many different forms with differing functions; this phenomenon is known as "Polymorphous crystallisation" of the state(M. Mann 1993). States' functions can be categorised into an array of social, cultural, ideological, economic and political (Poulantzas, 1973). The domination of each function of the state over the others depends on the social formation of that particular state.

Furthermore in order to secure the enforcement of their functions, the states should apply sanctions. These sanctions vary depending on the function as well as the policies of the state; some states use coercion and force, others impose less aggressive mechanisms depending on the circumstances. The functions and sanctions used by states and the links with other institutions in the domestic and international domain are contingent to the social formation. For instance in the Marxist conception, "*the state has the particular function of constituting the factor of cohesion between the levels of a social formation*" (Poulantzas, 1973, p. 44).

Disregarding the social formation and theoretical backgrounds, generally the state is recognised by its political function. The political function of the state is extensive and connotes the maintenance of political order (Poulantzas, 1973). The political function of the

state is a dynamic for cohesion in the unity of a social formation and thus economic, ideological, and social functions are overdetermined in it; to put it another way, "the various functions of the state constitute political functions through the global role of the state, which is the cohesive factor in a formation divided into classes" (Poulantzas, 1973, p. 54). Therefore all the functions of the state are, in a general sense, political. However in the narrower sense the political and other functions of the state are collateral. As Poulantzas elucidates: "though the state has the global function of cohesive factor in the unity, this does not in the least mean that for this reason it always maintains the dominant role in a formation, nor that when this dominant role is held by the economic, the state no longer has those functions of cohesive factor" (Poulantzas, 1973, p. 56). Thus the state may perform other functions – such as economic – along with its political functions.

The main concern of this thesis thus far has been with the economic function of the state and its role in investment as the host state. Notwithstanding, political and legal functions will be analysed in regard to performing this specific economic function.

One may classify states according to their economic functions into interventionist and non-interventionist. The theoretical perspective and policies of the state underpin the type and degree of the intervention of the state in the economy; accordingly there are various approaches in regard to the role of the state in the economy.

The first approach is that of the liberals and can be traced back to Adam Smith. The core idea of liberal thought is that private economic activities, their profit making objectives and the competition among them promote the efficiency of the economy. Smith called this 'the invisible hand' in the economy as opposed to the 'visible hand' of the states by their military power(Ingham 2008). According to this group, the role of states in economic affairs ought to be limited to exceptional circumstances, such as market failure. For this purpose states can interfere directly or indirectly. The direct duty of the state is to intervene in the projects that are either not profitable for individuals or are fundamental for the public such as infrastructural projects. The indirect task of the state in relation to economy is merely to maintain a safe environment and support the economy by appropriate rules and regulations.

State interventionism, as opponent approach, argues that the state should interfere in economic activities in order to establish and maintain equilibrium. The rationale behind their claim is that they believe "the fundamental market exchange in capitalism – that is, the

buying and selling of labour power – was inherently unequal"(Ingham 2008, 15). Thus the state has economic functions to control and balance any manipulation and inequalities.

Overall, states intervene in the domestic economic sector in two ways: "maintenance of the 'public good' of 'human capital', and the management and stabilization of the economy"(Ingham 2008, 191). The two economic functions of the state are exercised at the national level. The intervention of the state in the economic sector may be at various levels and by different organs of the state.

On an international scale a direct form of intervention in economic activities is where the state – or its dependent entities – enter into treaties with other states or conclude economic agreements (commercial and investment) with private parties. One aspect of the economic function of the state is the development of the country's economy and the wealth of its nation. The state pursues the latter function through foreign investment. In other words, states enter into investment contracts and treaties in order to improve the economic status of the country. The indirect intervention of the state in the economy is through its political and legal functions – however it is worth mentioning that, as stated earlier, the legal function of the state can be described as part of its political function in its general sense. The state may intervene indirectly by policymaking and regulating the economic relations and activities via its legislative power. Based on the separation of powers principle, the state has two legal functions to pursue: legislative and judicial. So far as the subject of this thesis is concerned, the judicial function of the state is not relevant – as the theme of the research is arbitration and not litigation by state courts – and the legislative function is the legal function of the state that shall be remarked.

Furthermore the state may intervene in economic relations through its executive power; that is "the *state apparatus*, i.e. the bureaucracy, administration, police, army" (Poulantzas, 1973, p. 308). The national and international policies of the state can affect economic – particularly investment – projects. This fact is more visible in the change of a political regime through election, revolution or any other forms, and transformation of power from one political party with some perspectives to other forms, which have significant influence on their policy towards the investment. In this regard, current investment projects may be affected by this change.

c. State Power

In order to perform their functions, states need pertinent power in relation to each function.[10] Accordingly some theories define the state on the basis of its mechanisms of power. Weber argues that "A compulsory political organisation with continuous operations (*politischer Anstaltbetrieb*) will be called a "state" insofar as its administrative staff successfully upholds the claim to the *monopoly* of the *legitimate* use of physical force in the enforcement of its order"(Weber 1978, 54). As mentioned earlier, states adopt different strategies and powers in securing compliance in enforcing their orders and functions; some reserve the right to suspend any provision against their policies, whereas others enforce their decisions by illegitimate manners such as illegitimate force, corruption and fraud(Jessop 2010). Force may be used differently; for instance the force used by a policeman is different from that used by a gunman (D'Entreves 1967). What makes the two forms of exercising force different is the legitimacy in enforcing power; one is authorised by law, the other is prohibited. When force is exercised on the basis of the order of law, it is deemed legitimate. The peculiarity of the modern state concerns the interdependence of law and the state, as is illustrated in Weber's definition by the phrase 'the legitimate use of physical force'. The state exercises power in accordance to and in the name of law(D'Entreves 1967). The last resort for states to secure compliance is by coercion and military power.

The notion of the state in the sense of state power links it to the concept of sovereignty. Furthermore, the state in investment arbitration has a dual role in investment arbitration: "the state as equal-level party to an arbitration and, simultaneously, as sovereign state" (Wälde, 2010, p. 180). Therefore, it is essential to elucidate the notion of sovereignty.
Sovereignty[11] is *the supremacy of the state powers;* it is "an authority that is supreme in relation to all other authorities in the same territorial jurisdiction, and that is independent of all foreign authorities" (Jackson 2007, 11). The general concept of sovereignty is further conceptualised according to the following typology: Westphalian sovereignty, international legal sovereignty, domestic sovereignty, and interdependence sovereignty(Krasner 2009).

[10] Consistently the power of states is crystallised on the basis of their functions and as far as this thesis is concerned the power of states is classified into political, legal and economic power, which shall be further discussed in the second chapter.
[11] "A sovereign state is not a particular form of constitution, such as a monarchy or republic or democracy. Nor is it a particular style of governance. Sovereignty is a political and legal foundation upon which various sorts of state constitution can be erected, and styles of governance carried on" (Jackson, 2007, p. 11).

"The medieval to modern transitions entailed the territorialisation of politics," (Rugman and Brewer 2001, 184) and it starts from the peace of Westphalia. This form of sovereignty is called the **Westphalian sovereignty** and it emphasises the non-interference into domestic affairs of a state. The Sovereign Equality principle was officially recognised by the Treaty of Westphalia signed in 1648. Later Vattel emphasised the importance of independence and non-intervention in domestic affairs of a state. The doctrine of Calvo is the best example of reference to sovereignty in the sense of non-intervention of states mainly by the powerful states. In modern times the Charter of the United Nations has approved the sovereign equality, necessity of independence of states and the principle of non-intervention.[12]

International legal sovereignty comprises two main principles: recognition of a state by other states, and the juridical equality of all states irrespective of their size, natural resources, population and other sources of power. The recognition of a state by other states is a formal and diplomatic issue; however it may have effects on the economic affairs of that state. For instance one relevant effect of the non-recognition of a state may be the reluctance of international companies to invest in that country. Moreover the advantage of international legal sovereignty is that it "offers the possibility for rulers to secure external resources that can enhance their ability to stay in power and promote the security, economic, and ideational interests of their constituents" (Krasner 2009, 190).

Domestic sovereignty (or internal sovereignty) is the authority and control of a state in its territory and thus is related to the power and capacity of a state to control its domestic affairs. "*Internal sovereignty* defines the legitimization of the state vis-à-vis competing domestic claimants"(Rugman and Brewer 2001, 184). In other words, internal sovereignty is the authority of a state within its territory and is limited to the state's boundaries. This authority of states includes determination of policies, rules and regulations in a specific territory (Rugman and Brewer 2001)(Hurrel and Woods 2002). According to the definition of internal sovereignty, there is no interaction between different states, and therefore the power of states is not confronted.

[12] Article 1.4 of the Charter of the United Nations: "All Members shall refrain in their international relations from the threat or use of force against the territorial integrity or political independence of any state, or in any other manner inconsistent with the Purposes of the United Nations."
Article 1.7 of the Charter of the United Nations: "Nothing contained in the present Charter shall authorize the United Nations to intervene in matters which are essentially within the domestic jurisdiction of any state or shall require the Members to submit such matters to settlement under the present Charter;..."
Article 2.1 of the Charter of the United Nations: "The Organization is based on the principle of the sovereign equality of all its Members."

Interdependence sovereignty is the capacity to control and regulate international movements of trade, investment, people, information, and capital (Krasner 2009). The weakness of states in regard to their interdependence sovereignty may impact their independence in their domestic affairs from intervention of other states(Krasner 2009). For instance the creation of international institutions and their transnational activities within the territories of states limits their Westphalian sovereignty.

In investment relationships, host states are on an equal level with investors; they are considered as parties of an investment relationship. On the other hand, sovereignty is the supremacy of state powers. From consideration of the two statements, a paradox appears that while the host state is on an equal level with investors, it is a sovereign and its powers are supreme.

The right to deviate from sovereignty can justify this paradox. Deviation from sovereignty is either voluntary or non-voluntary. The former can be by the consent of the state in the form of agreement or treaty. "A sovereign government is usually said to be a 'free' government in the sense that it is free from all foreign authority and law except that to which it has consented or otherwise subjected itself: for example, by means of a treaty" (Jackson 2007, 10). Therefore when host states enter into an investment relationship they impliedly limit the supremacy of their powers by consenting to be on an equal level to the other party – investors. Although states are autonomous in entering into agreements in the forms of convention, treaty, or contract, once entered there is the possibility that the agreement violates the independency of the state – Westphalian sovereignty – indirectly by a non-coercive way. "A contract can violate the Westphalian model if it alters domestic conceptions of legitimate behaviour, subjects domestic institutions and personnel to external influence, or creates transnational authority structures"(Krasner 2009, 202). In this process the more powerful states and non-state actors can affect the weaker states.

The opposing view is that states are interdependent and the international system consists of states and trans-governmental powers (Keohane 2002). Many issues and problems of the world such as environmental pollution are no longer related to a specific country; all countries are involved and therefore a single state cannot solve these problems(Keohane 2002). Thus, the sovereignty of states has become interdependent and to some extent limited from the international perspective.

The point, which is worth mentioning in respect to the international aspect of states' sovereignty, is the issue of states' inequality of power. According to Hurrel and Woods "Inequality has been a defining feature of world politics" (Hurrel and Woods 2002, 1). In 1974 the UN General Assembly adopted the Declaration on the Establishment of a New International Economic Order (NIEO)

> "based on equity, sovereign equality, interdependence, common interest and cooperation among all states, irrespective of their economic and social systems which shall correct inequalities and redress existing injustices, make it possible to eliminate the widening gap between the developed and the developing countries and ensure steadily accelerating economic and social development and peace and justice for present and future generations"

The NIEO expressly addressed the issue of sovereign equality of states. However, in practice the NIEO was not entirely fulfilled. Therefore there are different views among scholars. These views form a continuum of absolute equality to absolute inequality of states. Some naturalist scholars such as Vattel draw an analogy between equality of individuals and equality of states and believe that

> "since men are by nature equal, and their individual rights and obligations the same, as becoming equally from nature, Nations, which are composed of men and may be regarded as so many free persons living together in a state of nature, are by nature equal and hold from nature the same obligations and the same rights. Strength or weakness, in this case counts for nothing"(Hurrel and Woods 2002, 69).

In line with the naturalists' view, Article 2 of the United Nations Charter concerns the principles of the Organisation, the first principle declaring that: "The Organization is based on the principle of the sovereign equality of all its Members."(The Charter of the United Nations n.d.). In the General Assembly of the UN, each state irrespective of its power has one vote. Accordingly, the sovereignty and equality of states are fundamental precepts of the law of nations (Brownlie, 2008).

However, on the other side of the spectrum some claim that the theory, according to which sovereignty entailed equality, is no longer applicable (Hurrel and Woods 2002, 70). Based on this view, "universal formal equality of states in the sovereignty model has not resolved many of the underlying problems" (Hurrel and Woods 2002, 84). These theorists

believe that states with greater power have more responsibility and can use their power to balance disparities in order to provide peace in the world for all countries. This group argues that even in the United Nations (UN) – the Security Council – and other organisations such as the World Trade Organization (WTO) and International Monetary Fund (IMF), states are not considered equal. By way of illustration, in these organisations, the power of states is a determinant factor in their voting rights; thus, the principle of '*each state one vote',* which applies in the General Assembly, does not apply in some other units such as the Security Council. The impact of this belief is to accept that as the power of states is determinant in the process of decision making in the world, powerful states and the companies based in these states (MNEs) make all international rules and norms such as investment rules; thus weaker states are merely rule-takers(Hurrel and Woods 2002, 1).

There is a moderate view that while it does not accept the absolute equality of states it does not reject it either. This view considers sovereignty as "a bulwark against the iniquities of dominance by powerful external forces and a basis for identity and democratic decision-making," (Hurrel and Woods 2002, 68) while admitting that in practice there is inequality between states. Proponents of this view claim that the sovereign equality principle recognizes that all states are equal in law; nonetheless states may be unequal in other aspects such as their power, population and wealth. Therefore, from the perspective of international law, all states possess equal sovereignty. Oppenheim, one of the prominent supporters of this idea, distinguishes legal and non-legal aspects of sovereign equality, especially at the international level. Accordingly, there is no disparity before international law; the legal personality of the states is legally recognised and should be respected equally. It is true that in the real world the power of states is not equal; however, this inequality is not from the legal perspective. The middle view on the sovereignty of states is more rational than the two other views.
Considering these different views about the sovereignty of states, it can be concluded that neither the views at neither extreme are realistic; they each ignore some important issues that the moderate viewpoint attempts to emphasise. Nonetheless, the middle view is more rational in comparison to other theories.

Moreover, the point that is crucial in determining the impact of MNEs on the political power of states is to distinguish between the impact of MNEs on national and international sovereign power of states, and then it can be concluded that the international sovereign power is more vulnerable than the national one. The reason is the interdependency of states in the

international aspect of world politics and therefore in addition to MNEs the role of powerful states is another factor affecting international sovereignty of states, particularly developing countries that are mainly host states. However, the national sovereignty of states is also affected by MNEs: "Host governments face strong parent companies, who have considerable negotiating ability and bargaining power, which the governments try to offset by restrictions and regulations."(Behrman 1971-1972, 218). In this regard it is claimed that sovereignty – international legal and Westphalian – is hypocrisy (Krasner 2009); a legitimate appearance which is underlined when it is needed to gain more power. In other words, depending on the circumstances and interests of the more powerful states, sovereignty is sometimes claimed and sometimes rejected.

Consequently, with regard to the status of sovereign power of states in the modern world, it should be borne in mind that "authority and power are still identifiable, but the argument is that the concentration of these in any particular location has been so thoroughly checked, balanced, and dispersed that there is no traditional 'sovereign'"(Hurrel and Woods 2002, 81). What the world is facing as a modern concept of sovereignty is best described in the words of Kingsbury:

> "Sovereignty no longer enables states to exert effective supremacy over what occurs within their territories… what sovereignty does confer on states under conditions of complex interdependence is legal authority that can either be exercised to the detriment of other states' interests or be bargained away in return for influence over others' policies and therefore greater gains from exchange."(Hurrel and Woods 2002, 85).

As a final point, it is worth noting that the state is a subsystem (component) of the *states system*. The states system is a complex of all the states. While states preserve their independence and sovereignty, they have interconnection with other states within the states system. The states system is not an isolated system; it is an open system that has interaction with the surroundings in the environment; the environment consists of surroundings outside the borders of the system. The surroundings are non-state actors including transnational and non-governmental entities. Every system is affected by inputs from surroundings, and affects surroundings by its outputs; consequently there is interaction among systems and their components. Accordingly in the global system, states are interconnected and interact with non-state actors such as MNEs. In this process although it is believed that "national governments even when acting in concert with MNCs [Multinational Companies] are still the

fundamental political actors in international relations" (Kline 2006-2007, 125), the question is whether the economic power of MNEs dominates political actors, and whether in case of conflict between political and economic actors, legal power predominates in order to resolve conflicts. The following sections will further investigate the global system, its subsystems including the investors (MNEs), and conflict resolution systems (arbitration), as well as the interactions between them.

ii. Investors

Foreign investors are actors that make investment in a host state. Therefore the concept of investor can be described from two aspects: the personal, and the subject-matter aspect. From the personal aspect, investors are either individuals or companies. Although individual investors, and small and medium sized companies may be involved in foreign investment, in the majority of cases investors are MNEs. (Dolzer & Schreuer, 2008). MNEs have had a substantial impact on the global economic and political situation and their power can compete with that of states. As the objective of this thesis is to examine the power of investors *vis-à-vis* that of states, the power of MNEs is worth comparing with that of the states. Therefore an analysis of the powerful role and power that these giant corporations play in investment is an essential prelude to draw a parallel with state power. The first subsection below will therefore describe MNEs.

As for the subject-matter dimension, the concept of investor underpins the notion of investment. Investment is the function of investors and it can be claimed that investors are conceptualised in terms of what they do. Therefore it is essential to explore the meaning of investment, which is the task of the second subsection.

Multinational Enterprises (MNEs)

The late twentieth century saw a rapid growth of globalisation. One of the results of globalisation has been the rise of MNE and their power, particularly in comparison with the power of states. In order to clarify their power their nature will be delineated; and in order to elucidate the nature of this party, two issues will be explained: the definition of MNEs and their quality of being non-national in the host country.

The Organisation for Economic Co-operation and Development (OECD) guidelines define the term MNE as:

> "companies or other entities established in more than one country and so linked that they may co-ordinate their operations in various ways. While one or more of these entities may be able to exercise a significant influence over the activities of others, their degree of autonomy within the enterprise may vary widely from one multinational enterprise to another. Ownership may be private, state or mixed" (OECD Guidelines For Multinational Enterprises, 2008, p. 12).

Different terms such as multinational companies, transnational corporations and international companies, are often used interchangeably; however the word 'enterprise' is preferred as it is a more general and wider term that includes other terms – such as companies and corporations – and at "the top level of coordination in the hierachy of business decisions" (Caves 2007, 145).

What is noticeable about MNEs is that these corporations, as opposed to many other types of institutions, do not emerge from intergovernmental agreements; rather, they are formed as a consequence of governmental policies (Behrman 1971-1972). One policy is "the economic growth in the markets of advanced countries" (Behrman 1971-1972, 215). MNEs have played an important role in integrating the international economy and transferring technology from developed countries to other countries. In this respect "foreign direct investment is one of a multinational enterprise' s many activities, albeit an essential one for without the investment (however small) there is no extension of the firm and no internationalization that is fundamental to an analysis of the international business" (Rugman and Brewer 2001, 6).

After this examination of the definition of MNEs and their relation with foreign investment, the question now arises as to why investors are mostly foreign nationals. "The use of external resources, both capital and skills, is generally essential to the development process since few developing countries can generate adequate investment capital domestically at least until their development is well advanced" (Cherian 1975, 8). Therefore, the nationality of the investors is important in order to determine whether the investment falls under the category of foreign investment or not. The nationality of individuals "is determined by the law of the country whose nationality is claimed" (Dolzer & Schreuer, 2008, p. 47). However, identifying the nationality of corporations is not as easy as individuals. Different legal systems have various criteria to determine the nationality of the corporation; the most common criteria are "incorporation or the main seat of the business" (Dolzer & Schreuer, 2008, p. 49). According to the provisions of the International Centre for Settlement of Investment Disputes (ICSID) convention, individuals or juridical persons that have nationalities of contracting parties other than contracting states are considered as foreign investors and ICSID has jurisdiction over their disputes with contracting states.[13]

[13] Article 25(2): "(2) 'National of another Contracting State' means: (a) any natural person who had the nationality of a Contracting State other than the State party to the dispute on the date on which the parties

The bottom line is that the role of foreign investors is to promote *investment* in host states; therefore it is essential to examine the notion of foreign investment as the subject-matter dimension of the concept of investor.

a. The Notion of Foreign Investment

"Whereas international trade in goods and services is mainly governed by the WTO Agreement and its Annexes, there is no international legal equivalent for the governance of international investment, which constitutes a major part of international capital flow"(Aaken 2009). Conventions such as ICSID, investment treaties – including Multilateral and Bilateral Investment Treaties (BITs) – national laws, cases and doctrines are all instruments that have impact on different aspects of foreign investment including its definition and dispute settlement, which are two core issues of this thesis. Therefore, in this section in order to define the term 'foreign investment', all these instruments are considered (Cherian 1975).
According to the report of the United Nations Conference on Trade and Development (UNCTAD), "Investment does not have a generally accepted meaning." (UNCTAD World Investment Report n.d.). Moreover, the ICSID convention – the main convention specifically dealing with foreign investment – or as it is also named the Washington Convention does not provide a definition of investment; it merely states in Article 25(1) that ICSID has jurisdiction over disputes arising out of 'investment'.[14] It appears that this omission in defining investment is deliberate. The objective is that "the state party to the dispute would in any case have to specifically consent to arbitration, and the terms of that consent in most cases would include a definition (implied or explicit) of investment; the approach of the Washington Convention's drafters, therefore, was to provide the parties to a dispute maximal discretion to designate their transactions as an investment in order to subject the transaction dispute to investor-state arbitration under ICSID auspices" (Horn and Kroll 2004, 284).

consented to submit such dispute to conciliation or arbitration as well as on the date on which the request was registered pursuant to paragraph (3) of Article 28 or paragraph (3) of Article 36, but does not include any person who on either date also had the nationality of the Contracting State party to the dispute; and (b) any juridical person which had the nationality of a Contracting State other than the State party to the dispute on the date on which the parties consented to submit such dispute to conciliation or arbitration and any juridical person which had the nationality of the Contracting State party to the dispute on that date and which, because of foreign control, the parties have agreed should be treated as a national of another Contracting State for the purposes of this Convention."

[14] ICSID Convention Article 25 (1): "The jurisdiction of the Centre shall extend to any legal dispute arising directly out of an investment, between a Contracting State (or any constituent subdivision or agency of a Contracting State designated to the Centre by that State) and a national of another Contracting State, which the parties to the dispute consent in writing to submit to the Centre. When the parties have given their consent, no party may withdraw its consent unilaterally."

Regarding the case law, in cases where the agreement is absent of a definition by the parties, the tribunal has the duty to interpret whether the dispute falls within the field of foreign investment or not. "It almost goes without saying that the notion of investment is fundamental to the institution of investment arbitration, and that crafting a workable definition has occupied the attention of arbitrators and commentators in recent years."(Horn and Kroll 2004, 1). In *Salini v. Morocco* (2003) some criteria are provided in order to recognize whether a dispute is an investment dispute or not. These criteria set forth in this case are now known as the *Salini* test and are commonly used by arbitrators in different cases as a framework. The *Salini* test comprises the following elements: contribution of the investor, certain duration of the project, existence of operational risk, and contribution to the host state's development. "While the four criteria are today generally recognized as constituting the definition of an investment, it has not been fully clarified whether and to what extent all four criteria have to be met in each case" (Dolzer & Schreuer, 2008, p. 69).

Multilateral treaties define investment in different terms but to some extent they include a similar notion. For instance, Article 1(6) of the Energy Charter Treaty (ECT) defines investment as "every kind of assets owned or controlled directly or indirectly by an investor…". Article 1139 of the North American Free Trade Agreement (NAFTA), in order to define investment, provides a broad list of economic activities.[15]

BITs generally provide a broad definition for investment, such as 'every kind of asset'. For instance, under Article 1 of the BIT between Iran and Spain, investment is defined as follows:

[15] Article 1139 NAFTA: "investment means: (a) an enterprise; (b) an equity security of an enterprise; (c) a debt security of an enterprise (i) where the enterprise is an affiliate of the investor, or (ii) where the original maturity of the debt security is at least three years, but does not include a debt security, regardless of original maturity, of a state enterprise; (d) a loan to an enterprise (i) where the enterprise is an affiliate of the investor, or (ii) where the original maturity of the loan is at least three years, but does not include a loan, regardless of original maturity, to a state enterprise; (e) an interest in an enterprise that entitles the owner to share in income or profits of the enterprise; (f) an interest in an enterprise that entitles the owner to share in the assets of that enterprise on dissolution, other than a debt security or a loan excluded from subparagraph (c) or (d); (g) real estate or other property, tangible or intangible, acquired in the expectation or used for the purpose of economic benefit or other business purposes; and (h) interests arising from the commitment of capital or other resources in the presence of an investor's property in the territory of the Party including turnkey or construction contracts, or concessions, or (ii) contracts where remuneration depends substantially on the production, revenues or profits of an enterprise; but investment does not mean, (i) claims to money that arise solely from (i) commercial contracts for the sale of goods or services by a national or enterprise in the territory of a Party to an enterprise in the territory of another Party, or (ii) the extension of credit in connection with a commercial transaction, such as trade financing, other than a loan covered by subparagraph (d); or (j)any other claims to money, that do not involve the kinds of interests set out in subparagraphs (a) through (h)."

"The term 'investment' refers to every kind of asset invested by the investors of one Contracting Party in the territory of the other Contracting Party in accordance with the laws and regulations of the other Contracting Party, including the following: (a) movable and immovable property as well as rights related thereto such as leases, mortgages, liens, pledges and usufructs; (b) shares in and stock and debentures of a company or any other form of participation in a company or business enterprise; (c) title to money or to any performance associated with an investment and having economic value; (d) intellectual property rights; technical processes, know-how and goodwill; 2 (e) any rights having an economic value including rights to search for, extract, or exploit natural resources. Any change in the form in which assets are invested or reinvested does not affect their character as investments if such a change has been made in accordance with the laws and regulations of the host Contracting Party and with the approval of the competent authority of the host Contracting Party, if required."

Furthermore the US Model BIT 2012 in Article 1 defines investment as follows:

"**"investment"** means every asset that an investor owns or controls, directly or indirectly, that has the characteristics of an investment, including such characteristics as the commitment of capital or other resources, the expectation of gain or profit, or the assumption of risk. Forms that an investment may take include:

(a) an enterprise;

(b) shares, stock, and other forms of equity participation in an enterprise;

(c) bonds, debentures, other debt instruments, and loans;

(d) futures, options, and other derivatives;

(e) turnkey, construction, management, production, concession, revenue-sharing, and other similar contracts;

(f) intellectual property rights;

(g) licenses, authorizations, permits, and similar rights conferred pursuant to domestic law; and

(h) other tangible or intangible, movable or immovable property, and related property rights, such as leases, mortgages, liens, and pledges."

Although it is claimed that "the BITs have become the primary source of state consent to investment arbitration, reducing the significance of the investment definition in local legislation," (Horn and Kroll 2004, 286) the definitions of investment under national laws are provided here, because they are one of the instruments used in the field of investment.

National investment laws define investment in a narrower sense than BITs. For instance, under Article 1 of the Iranian Foreign Investment Promotion and Protection Act 2002 (FIPPA), foreign investment is defined as: "Utilization of Foreign Capital in a new or existing enterprise after obtaining the Investment License. Foreign Capital is various types of capital, whether in cash and/or non-cash (in kind), imported in to the country by the Foreign Investor, and comprising the following: a) Cash funds in the form of convertible currency, imported in to the country through the banking system or other methods of transfer acceptable to the Central Bank of the Islamic Republic of Iran; b) Machinery and equipments; c) Tools and spares, CKD parts and raw, addable and auxiliary materials; d) Patent rights, technical know-how, trade marks and names, and specialized services; e) Transferable dividends of foreign investors; f) Other permissible items approved by the Council of Ministers."

According to scholarly definitions, "A foreign investment consists of a transaction made by a foreigner in a host state which is intended to set up a long term relationship with a party in the host state, usually, the state itself or a state entity" (Sornarajah, 2000, p. 4). Foreign investment entails "the transfer of tangible or intangible assets from one country into another for the purpose of use in that country to generate wealth under the total or partial control of the owner of the assets" (Sornarajah, 2010, p. 4).

Finally, the Encyclopaedia of Public International Law defines foreign investment as "a transfer of funds or materials from one country (called the capital exporting country) to another country (called the host country) in return for a direct or indirect participation in the earnings of that enterprise" (Encyclopedia of Public International Law n.d.).

In addition to the aforementioned definitions, foreign investment can be examined by distinguishing between two types: Foreign Direct Investment (FDI) and Portfolio Investment (PI). In 1960, David Lilienthal was the first to distinguish between portfolio and direct investment (Rugman and Brewer 2001). A direct investment involves some elements which distinguish it from other similar concepts: the transfer of funds, a longer project, the purpose of regular income, the participation of the person transferring the funds, at least to some extent in the management of the project, and a business risk[16] (Dolzer & Schreuer, 2008).

[16] "Foreign direct investment (FDI) is defined in IMF as investment that is made to acquire a lasting interest in an enterprise operating in an economy other than that of an investor, the investor's purpose being to have an effective choice in the management of the enterprise." (Sornarajah, 2010, p. 4)

On the other hand, "portfolio (equity) investment (PI) entails the purchase of shares in a company or productive enterprise, usually through a stock exchange. The purchase of more than 10 per cent of the capital of a company is classified as FDI rather than PI. Such a purchase gives the investor significant influence" (Evans n.d.). Therefore, the element of management and control over the project, distinguishes these two concepts. Another difference between FDI and PI is that, in the latter there is no need for the presence of the foreign investor in the host country, whereas the foreign investor in a FDI is continuously present in the host state (Dolzer & Schreuer, 2008). As a result, risk in a portfolio investment is upon the foreign investor himself, whereas in a FDI protection of the foreign investor is recognized under international law (Sornarajah, 2010).

Overall, as examined in this section, there is no unique and generally accepted definition for foreign investment. However, the characteristics of foreign investment clarify its notion to some extent. Put another way, foreign investment falls within the broad category of international commercial law (Sornarajah, 2000); though, some peculiarities have rendered foreign investment distinct from international commerce in some respects.

The first characteristic of foreign investment is the nature of the parties involved. Most of the agreements are either between states or between persons – natural or legal persons. Foreign investment is a state-investor relationship and thus one of the pillars of foreign investment is the state. States – as examined in the previous part – have fundamental roles in the process of foreign investment from its creation to its end. Emergence of foreign investment can either be through treaties – mainly BITs – or contracts. In the former case, both home and host states are engaged in the foreign investment process. States may be present in foreign investment as the host, directly or indirectly. A state may be the host of investment indirectly where foreign investment is between an investor and a state entity and thus "the state is an unseen presence in the transaction" (Sornarajah, 2000, p. 7). In this case, the state interferes in the investment contract for controlling and implementing national policy by its political and legal power. The direct intervention of states in foreign investment is in pursuing their economic function for the development of their country.

Furthermore, investors are mainly from powerful developed countries, and consequently home states engage in foreign investment by providing support for their investors. "In pursuance of this goal, it would have made bilateral investment treaties and advocated international standards according to which foreign investment should function and

should be protected" (Sornarajah, 2000, p. 8). The interference of home states is direct by making BITs with host states. "A state in a sense protects its own economic resources when it protects its foreign investors as the assets taken abroad could well have been utilized at home" (Sornarajah, 2000, p. 8). Home states are not present in foreign investment agreements that are usually signed between foreign investors and host states. Home states become involved in the investment relationship through the diplomatic protection of investors, in case of conflict. It should be borne in mind that diplomatic protection is one of the forms of conflict resolution in foreign investment and so far as the topic of this thesis is concerned arbitration, and not other forms of conflict resolution, will be examined.

As a result of the nature of the parties involved in foreign investment, another characteristic arises that foreign investments are unique in that they are neither fully private nor public; as the parties are not all private parties and are not public (states). Thus, these types of activities cannot be governed solely by commercial or public law, but rather by a combination of commercial and public law internationally.

The other peculiarity of foreign investment relates to the issue of the time of performing investment. The duration of performing ordinary commercial contracts may vary depending on their nature of being domestic or international, however, mostly they are short-term. For instance, a simple sale contract is performed by payment of the price and delivery of the goods. Foreign investments, on the other hand, are mainly long-term activities; sometimes running up to thirty years or even more. "The exposure to risk, the change of circumstances, the fluctuation in price and the imbalances that may occur over time in the original bargain, set the long-term contract [including foreign investment] apart from the ordinary commercial contract" (Sornarajah, 2000, p. 30).

Accordingly the long-term nature of foreign investment leads to the other characteristic, which is the issue of risk in foreign investment, to be triggered. The long duration of foreign investment increases the risk of conflict in this process. It is claimed that, "it is the nature of the risks that compels the argument that the foreign investment transaction should be regarded as a unique international transaction different from other transactions" (Sornarajah, 2000, p. 29).

Risk in foreign investments is dual; both the investor and the state take risks in an investment process. During a lengthy period of an investment process, government may alter;

as a result of that, the policies regarding investment in the host state may change in a way that may even prohibit any foreign investment activities within the territory.

The aforementioned characteristics render foreign investment law a specific branch of legal studies; consequently, conflicts that arise out of foreign investment and resolution of these conflicts have specifications that render them different from other types of conflicts.

Hence, foreign investment can be defined as a phenomenon under which capital flows, productivity and technology[17] are transferred by investors, as the owners of the capital and technology, to host states which are mainly developing countries to seek profit through investment activities in the territory of another state. In other words, the objective of the host states is to promote national economic development, while the investors' aim is to enhance their own competitiveness and profit in an international context (Cherian 1975). Thus, foreign investment is an exchange relationship based on mutual profits and benefits of host states and investors, in which power is an essential element to attain the interests.

[17] Capital, productivity, and technology are paradigms of economic power that investors possess in their relationship with host states. This issue is further discussed in Chapter 1(C) on Power and Chapter 3 on the powers of the investment parties.

iii. Arbitrators

International arbitration has become the principal method of resolving conflicts between states and individuals. The rationale behind the emergence of arbitration particularly in the field of foreign investment is to reduce the inefficiencies of the traditional conflict resolution mechanisms – such as litigation in domestic courts and diplomatic protection – as well as obtaining private justice according to the needs of the parties. Consequently the "effective international remedy" is claimed to be the main incentive – particularly for investors – in referring to arbitration (Dolzer & Schreuer, 2008, p. 221). In order to ascertain the role of arbitrators in the three-dimensional relationship of investment, it is essential to explore the nature of arbitration at the outset.

As a focal issue of this thesis, arbitration will be analysed from a power dynamic perspective. The aim is to assess the power of arbitrators not only to resolve conflicts – as their main function – but also to restore the equilibrium between the conflicting parties. Power is a means through which arbitrators exercise their duties and functions. Duties of arbitrators depend initially on the perception of the status of arbitrators: arbitrators as quasi-judicial actors like judges, as agents of the parties, as a hybrid of judge and agent, or as an autonomous neutral third party dispute resolver. The status of arbitrators is itself rooted in theories of the nature of arbitration. In other words, different theories of arbitration allocate different status to arbitrators, and the type and degree of their powers varies according to their status. Thus the process of the study of arbitrators and their power is a study of a chain of intertwined concepts: the **nature** of arbitration (which is analysed by the theories of arbitration), the **status** of arbitrators (which is determined by the theories of arbitration), and the **power** of arbitrators (which is entwined with the nature and status of arbitration). In the following two subsections the nature and status of arbitrators will be explored through different theories in subsection **a**, and then the conception of investment arbitrators shall be delineated in subsection **b**. The power of arbitrators as the core of the research will be explained in Chapter 3.

a. The Nature and Status of Arbitration

There are different theories on the legal nature and position of arbitration. Four main theories are identified and have been developed since the proliferation of arbitration in the

twentieth century. Jurisdictional theory, contractual theory, mixed theory and the autonomous theory are the main schools of thought on the nature of arbitration (Gaillard and Savage 1999) (Lew, Mistelis and Kroll 2003)(Onyema 2010) (Yu 2008). Each theory allocates a specific status to arbitrators in regard to their roles in relation to conflict and the conflicting parties. The status of arbitrators determines the extent of their duties and rights as well as the scope of their power to settle a conflict. In other words each of the theories responds to the question of the status and power of arbitrators according to its principles and postulates. Furthermore the status of arbitrators elucidates the relationship between the arbitrator and the disputing parties and consequently the position of the arbitrator in relation to them.

The Jurisdictional Theory

According to the jurisdictional theory international arbitration is supervised by the states and the states' regulations within their jurisdictions (Yu 2008). The jurisdictional theory focuses on the sovereignty of the state particularly the *lex fori* – which is the law of the place where the arbitration takes place – and the state where recognition and enforcement of the arbitral awards is sought (M. Mann 1993). Although the proponents of the jurisdictional theory do not deny the autonomy of the parties in regard to arbitration agreement, they confine it to the limits of the states' sovereignty and particularly the *lex fori*. They believe that "The interpretation and application of the law and the determination of disputes is a sovereign function normally exercised by national courts established by the state for that purpose" (Lew, Mistelis and Kroll 2003, 75). Therefore, according to this theory, arbitration is considered as an exceptional private conflict resolution method, which is allowed by the state and the law of the seat.

Mann, one of the supporters of this theory, believes that international arbitration is a misnomer, as arbitration is "subject to a specific system of national law"(F. A. Mann 1983, 244). As he asserts: "Every right or power a private person enjoys is inexorably conferred by or derived from a system of municipal law which may conveniently and in accordance with tradition be called the *lex fori*, though it would be more exact (but also less familiar) to speak of the *lex arbitri* or, in French, *la loi de l'arbitrage*" (F. A. Mann 1983, 245).

This theory is based on the assimilation and comparison between judges and arbitrators. The reasoning behind this assimilation is that both arbitrators and judges are subject to the local sovereign(F. A. Mann 1983). The proponents of this theory compare arbitrators with judges and argue that "the arbitrator performs functions as an alternative (though private)

judge as permitted under the national law (or international convention which the state has implemented) of the particular sovereign state" (Onyema 2010, 33). Their justification is that, as the state exercises control over judges and the litigation process within its territory, an analogy can be drawn between arbitration and court litigation. Accordingly an arbitrator is an adjudicator who is merely appointed by the parties but derives his power from the local law – the state.

The assimilation is mainly concentrated on the power and authority of arbitrators and judges. The power of an arbitrator, like a judge, derives from the law; moreover as many principles applicable to judges are applicable to arbitrators, such as the impartiality and neutrality, arbitrators are treated like judges(Lew, Mistelis and Kroll 2003). On the basis of this theory arbitrators are regulated by the state and thus their power originates from it. Furthermore this theory is emphatic that arbitrators are alternatives to state judges and have a quasi-judicial function(Lew, Mistelis and Kroll 2003).

One of the functions and consequently powers of the state is the judicial function. In order to settle a dispute, an arbitrator must gain his judicial power from the state. "According to the delegation theory, in order to settle disputes between parties, an arbitrator must possess a delegated authority given by a state in which he sits to conduct an arbitration" (Yu 2008, 261). Therefore the state delegates power to arbitrators to settle conflicts. In other words, on the basis of the jurisdictional theory, arbitrators' power can only derive from a national legal order. The main criticism of the jurisdictional theory is that it constrains the function of arbitration at the international level, particularly international investment conflicts.

The Contractual Theory

The contractual theory emphasises the role of the conflicting parties in the formation and continuation of arbitration. The contractual theory is based on the assumption that arbitration is the "illustration of freedom of contract and an almost unlimited party autonomy, *i.e.* a private justice system" (Lew, Mistelis and Kroll 2003); thus the state has no control over the arbitration process. The core idea of contractual theory can be summarised as follows:
"The proponents of the contractual theory believe that the settlement of the dispute in arbitration should not be influenced by the power of any states and that the concept of *pacta sunt servanda* should prevail, binding the parties to perform the arbitration agreement made between them without state's pressure" (Yu 2008).

Accordingly, the relationship between the conflicting parties and the arbitrator is a relationship based on a contract. Thus according to this approach, an arbitrator is not similar to a judge. With regard to the status of arbitrators, the contractual theory supports the agent theory under which the arbitrators do not perform a public function and are merely proxies of the conflicting parties to settle their disputes(Yu 2008). Arbitrators are agents of the parties that appoint them and resolve their disputes according to their agreements. This approach dismisses the state power over arbitration and instead assumes that the power of arbitrators is merely originated from the parties; arbitrators are empowered by the parties to decide the parties' conflict.

There are some criticisms of the application of agent theory on the status of arbitrators. These criticisms are based on the genuine differences between the concept and functions of agent and arbitrator. An agent is a person who acts on behalf of the principal and for the interests of the principal. An arbitrator, though possibly appointed by one or both of the parties, is assumed to be impartial and independent. To put it another way, as the interests of the parties are in conflict – which is why they refer to an arbitrator to resolve their disputes – acting in the best interests of either party would be at the expense of, or at least of no interest to, the other party as well as rendering the arbitrator biased.

Furthermore, an agent performs on behalf and with the authorisation of the principal the functions that the principal can perform himself; whereas "Arbitrators can perform functions which can never be performed by the parties, such as the power to summon witnesses in certain countries or order security of costs against one of the parties"(Yu 2008, 270).
The dominant view is that "The arbitrator does not represent the parties, and certainly not the party which appointed him or her. Rather, the arbitrators assume a judicial power of their own" (Gaillard and Savage 1999, 605). Thus, it is not accurate to assimilate arbitrators to agents.

The Hybrid (mixed) Theory

As examined above, the two extreme schools of thought on the nature of arbitration and the status of arbitrators – the jurisdictional and the contractual theories – have deficiencies. The mixed theory integrates the main remarks of the two mentioned theories: the autonomy of the parties and the control of the state in the arbitration process. Nevertheless under this approach the role of party autonomy and the state are circumscribed. The parties' autonomy is

fundamental in the initiation of arbitration proceedings, and then arbitrators are to make decisions without exercising judicial power on behalf of the state(Lew, Mistelis and Kroll 2003). Accordingly the disputing parties have the power to appoint arbitrators and determine the applicable law. This aspect of the hybrid theory is based on the contractual theory. Nonetheless the determination of the power of the parties, the validity of arbitration agreement and enforcement of the awards, are jurisdictional issues and beyond the autonomy of the parties(Yu 2008).

Consequently, the arbitration agreement is based on a private agreement between the disputing parties and the arbitrators. Nevertheless, once the arbitration agreement is formed, arbitrators are independent from the parties and possess quasi-judicial functions like judges. The opponents of hybrid theory maintain that "arbitrators obtain their powers from the parties' authorisation and they are allowed to act on behalf of the parties within the scope of authorisation"(Yu 2008, 277). However their power is confined by the rules and public policy of the place of arbitration. Therefore it can be claimed that arbitrators under the hybrid theory have a dual role: as judges and agents.

Although the mixed theory to some extent redresses the deficiencies of the jurisdictional and contractual theories, it cannot best serve international purposes. In some conflicts, such as investment disputes, the strings of the dispute and the disputing parties are so detached from national jurisdictions that they cannot have any relation with a specific national law.

The Autonomous Theory

The widespread use of arbitration and its development have rendered it an autonomous means of conflict resolution along with litigation and other forms. Therefore as a result of its particular nature, arbitration cannot be investigated as part of the general theories applicable to various dispute settlement mechanisms. It is claimed that "the character of arbitration could, in fact and in law, be determined by looking at its use and purpose"(Lew, Mistelis and Kroll 2003, 81).

The autonomous theory is a developed and integrated idea of the nature of arbitration. It considers arbitration as an independent institution with unique characteristics and functions. "The effect of the autonomous theory therefore is the acknowledgement and recognition of the delocalization of arbitration, the complete detachment of international arbitration from the

laws and courts of the seat of arbitration, and the supremacy of party autonomy as the controlling force in international commercial arbitration references"(Onyema 2010, 40).
The increase of transnational relations of commerce and investment as well as the general perception of most of the arbitrators has led to the conclusion that arbitrators "do not administer justice on behalf of a given state, but that they nonetheless play a judicial role for the benefit of the international community" (Gaillard, 2012, p. 68).

b. Arbitrators in Investment Conflicts

Among different theories of arbitration the autonomous theory is the most pertinent theory for investment arbitration. The nature of international investment arbitration is itself contested in the sense that it meets the elements of both a public international law tribunal and private commercial law arbitration, and has its own characteristics. Accordingly there are two perspectives on the nature of international investment arbitration: the public international lawyers' perspective and the international commercial arbitrators' perspective (Mills, 2011). The discussion of these two perspectives assimilates with the discussion on the comparison between the role of judges and arbitrators.

The traditional difference between arbitrators and judges is rooted in the private nature of arbitration as opposed to the public function of adjudication by judges. Judges unlike arbitrators have a duty to resolve conflicts while considering the public and social interests, whereas arbitrators as private adjudicators merely resolve conflicts within the authority conferred to them.

Furthermore the power of a court judge is originated from the state. In their decision-making, judges have a duty to consider public policy and the interests of society. Thus the role of a judge is to dispense public justice.
"The position differs in arbitration, particularly in international arbitration, where the powers, duties, and jurisdiction of an arbitral tribunal arise from a complex mixture of the will of the parties, the law governing the arbitration agreement, the law of the place of arbitration, and the law of the place where recognition or enforcement of the award may be sought" (Redfern, et al. 2009, 313).

Arbitration, and particularly commercial arbitration, is based on the will of the parties. Initially, arbitrators gain their power from the parties. However, once the parties confer power to arbitrators to resolve their disputes, arbitrators are equipped with legal power and are

independent from the parties. In other words, although the origin of the arbitrators' power initiates from the parties, in exercising their power they are to some extent independent from the parties. The arbitrator possesses judicial power and in this stage the role of the arbitrator can be assimilated to that of a judge.

Moreover, the powers of judges and arbitrators differ in their degree and forms. A court's judge possesses coercive power obtained from the state. A judge can compel the parties to appear before the courts; the arbitrator does not have this type of coercive power. "This power is the characteristic that typically distinguishes courts from other dispute resolvers such as go-betweens, mediators, and arbitrators" (Helfer and Slaughter 1997, 283). Additionally, the difference between arbitrators and judges lies in the mechanism of their nomination; the sovereign state nominates judges whereas arbitrators are nominated either by the parties or by the appointing institutions (Lew, Mistelis and Kroll 2003).

Therefore there are fundamental differences between the role of arbitrators and judges. Whether the role of arbitrators in investment conflicts is closer to the role of judges or commercial arbitrators, determines the nature and power of them. On the one hand, there is a claim that arbitrators in investment disputes merely have the duty to resolve disputes and administer private justice between the parties disregarding the public factors. Put differently, arbitrators in investment conflicts have the same roles as in commercial disputes; they are "'private' dispute resolution 'service providers'" (Mills, 2011, p. 484).

On the other hand, the host states are prone to consider a 'quasi-judicial' role for arbitrators in order to increase their duty in respect to the public interests of the states. They believe that "Investor-State arbitration is not only a mechanism to settle disputes between an investor and a state arising out of an investment, it is also a form of global governance that involves the exercise of power by arbitral tribunals in the global administrative space" (Kingsbury and Schill 2009, Abstract). Primarily, the function of arbitrators is to settle individual conflicts between parties; additionally they act as global governors to structure the global administrative law. Arbitrators interpret BITs, set standards and principles that may be used as precedents in future disputes, and assess the actions of host states – such as the regulatory power for public interest of the country – vis-à-vis private interests of investors – such as fair and equitable treatment (Kingsbury and Schill 2009). Therefore arbitrators' decisions not only affect the direct disputing parties, but the host state's nation.

Each of the two perspectives on investor-state arbitration leads to diametrically different conclusions. Notwithstanding, the recent trend is to increase the public aspect of investment arbitration, which will consequently affect the legitimacy and effectiveness of the system.[18] Based on the analysis of the subsequent chapters of this thesis, on the legitimacy of arbitration, an arbitrator in investment arbitration is a third party to the agreement and the dispute between investors and states, and which has the duty to resolve disputes and consider the public interests.

Eventually it will be remarked that the relationship between the parties and the arbitrators is based on a contract (Gaillard and Savage 1999).[19] In the relationship between parties and arbitrators, the parties appoint the arbitrator to resolve their conflicts in return for remuneration; thus there is a contract between them. It is worth mentioning that in institutional arbitration, the role of the institution is to administer the process and appoint the arbitrators on behalf of the parties. Although there are considerable controversial views on the type of arbitrator-disputants' contract, one characterisation of the contractual relationship of the parties and arbitrators – which is relevant to the present topic – is that it is a contract of empowerment under which "the parties empower one or more arbitrators to resolve their conflicts, and those arbitrators undertake to exercise that power and to perform that task"(Gaillard and Savage 1999, 608). Thus it can be claimed that "Arbitration is a delegated and restricted power to make certain types of decisions in certain prescribed ways"(Reisman 1992, 1). Arbitration is a means of conflict resolution. Conflict and power are two interrelated concepts. "Power has been called "the architect of conflict" because it enables people to use the resources available to them and to communicate the power that moves a conflict along to its end. Power shapes the perceptions people have of their choices and their estimation of the other is behavior in conflict situations" (Lulofs and Cahn 2000, 143). Therefore in studying conflict resolution – here arbitration – it is inevitable to consider the concept of conflict and power. The following part will investigate the concept of conflict in general and in regards to investment. Thereafter, in the final part of this chapter, in order to ascertain the power of arbitrators, as well as the conflicting parties, the notion of power will be explained.

[18] This issue will be discussed further in subsequent chapters.

[19] Under the Common Legal systems, there is no unified definition of contract; though as Civil Law systems are codified, contract is defined manifestly in codes. For instance, according to Article 1101 of the French Civil Code "a contract is a convention under which one or more persons are obliged towards one or more other persons to confer, perform or not to perform an action." The bottom line is that a contract, in any legal system, is an agreement between two or more parties and consists of an offer, acceptance, intention and consideration.

D. Concluding Remarks

"Arbitration serves as a place of exchange between law [politics] and business" (Dezalay and Garth 1996, 203). Having examined its principles and dynamics, it can be argued that the exchange approach is an appropriate theoretical framework to examine the relationship between the main actors in foreign investment (investors, states, and arbitrators). More importantly this theoretical framework properly links the core dynamics of this thesis such as power and conflict.

From a theoretical perspective the investor/state/arbitrators relationship can be explained in light of the exchange theory. Investment is based on an exchange relationship between the host state and investors, and the principles of exchange theory can be applied to the exchange relationship between host states and investors. Both investors and host states have resources that the other party does not possess or possess lower valued resources. The distribution of scarce resources, the difference in the nature, and the value of these resources, results in the need to exchange resources that are owned by some actors, with those that are possessed by other actors. The parties of an investment enter into an investment contract or investment treaty in order to benefit. Therefore according to the rationality principle each party has an objective to gain rewards and benefits. The major concern is whether the exchange relationship between investors and host states is based on fair norms and whether they obtain a fair proportion of rewards in exchange for the costs they incur. In order to examine the justice principle in exchange relations, it is necessary to assess the power of the parties and discover whether there is inequalities and imbalances of power.

Overall it can be concluded that in an investment relationship one of the parties, for instance the investor is more powerful than the host state, when the host state is dependent on the investor for the resources available to it. The investor is less dependent on the host state, when there are no other suppliers or few suppliers other than the investor in the market. In these situations the relationship between host states and investors is asymmetrical. It is at this stage of the exchange relationship that one party may exert excessive power on the other to extract more rewards in comparison to the costs that it incurs. To put it another way, in interactions some actors offer more valuable resources than others, and inequlality of resources leads the more powerful party to gain more benefit in its reciprocal relationship with the less advantaged party. For instance, in the relationship between a host state with

natural resource such as oil, and an international oil company, when the competition among investors is high and there are few countries with oil, then the investors are more dependent on the host state.

Consequently, power plays an essential role in an exchange relationship. With regard to international commercial arbitration, it is argued that "the general logic of this system is determined in each country principally by the structure of relations between the legal field and that of economic power" (Dezalay and Garth 1996, 126). As for investment arbitration, it is of importance to add political power to the above statement. Put it differently, the system of investment arbitration is determined by the structure of relations between legal, economic, and political power. Therefore for international investment arbitration, as the focus of this thesis, it is crucial to underline power in economic, legal, and political filed to take charge of conflicts in investment.

CHAPTER 2: POWER IN THE PRE-ARBITRATION PHASE

The preceding chapter attempted to shed light on the key concepts of the thesis: the players, conflict, and power. The aim was to elucidate the preliminary notions and pave the way for a theoretical analysis of the subject. The remaining parts of the thesis will be devoted to a sketch on the interaction between the parties' powers in different stages of an investment from formation to conflict resolution with an emphasis on resolution by arbitration. The objective is to explore the central conceptual threads, which will bind the three-dimensional relationship of power together as an efficient network of relationships during the whole process of investment.

The process of investment can be studied in an array of three phases, and power as an omnipresent issue can be explored in every stage. The first stage is the bargaining or negotiation for formation of an investment via BITs or investment contracts. BITs and investment contracts are the law in the investment relationship. The law defines the rights and duties of the parties and consequently the legal powers that they can have based on their rights. Thus BITs and investment contracts define the scope of the rights, duties and legal power of the parties. The political and economic powers are intrinsic elements in bargaining, formation of the law, determination of rights and allocation of legal powers.

Following the phase of bargaining and 'Formation of the Law', the second stage is the performance of investment. In this phase the parties exercise their legal powers – which were determined in the bargaining phase. A crucial characteristic of investment relationships is that they are generally long-term; in the passage of time, the relative power of the parties might shift and they may misuse their legal powers to alter their initial bad bargain and to attain their interests.

During the performance of the investment a conflict may arise that takes the process to a third phase: the 'Resolution of Conflict'. This phase will not be dealt with until the following chapters; however for now it suffices to say that the third chapter is devoted to an examination of the role of arbitrators in regard to the substantive and procedural aspects of conflicts and the power of the parties, and the final chapter normatively justifies that the legal power of arbitrators must rule and shall not be dominated by the power of the parties.

This chapter is split into two parts. The first will sketch out the interaction of powers of the players in the primary phase of an investment: bargaining. At the outset, the notion of bargaining, which is a necessary stage for the formation of the law, will be examined. It is essential to explore the concept of bargaining power as a central element of bargaining. Economic and political powers of the parties as the predominant powers in bargaining will be pointed out.

The second part is devoted to an analysis of the powers that the parties exert during the performance of investment. First the legal power of the parties will be identified. Identification of the legal power presupposes insight into its concept in the context of the investor-state relationship. Therefore a theoretical explanation of legal powers is provided. Then the private and public interests of the parties are analysed. For this purpose, the correlation between rights, power, and interest is conducive to closer study. The conflict of interests between public interests of host states and private interests of investors are crystallised in their regulatory and protective rights respectively. Thus the chapter will conclude by addressing this conflict of interest which is one of the common and recent challenges to the investment system.

The solutions to the challenges discussed in this chapter will be dealt with in the following chapters. Accordingly the power of arbitrators, as the third limb of the investor-state arbitration relationship, will be scrutinised in respect to each of the above-mentioned phases respectively. As for the bargaining phase the doctrine of inequality of bargaining power will be discussed, and in regard to the exercise of power in the performance of investment, the principles of balancing and proportionality are considered as tactics to deal with the issue of power in investment relationships.

A. Bargaining Phase

This part is subdivided into two sections. First, the notion of bargaining in general and in the context of investment will be described. Second, the concept of bargaining power as the core dynamic of bargaining will be explored. The political and economic powers of the parties will be identified in this section. The aim of this part is to explore the powers of the parties in the preliminary stage of formation of the investment relationship.

I. The Notion of Bargaining

The relationship between investors and host states is a combination of cooperation and competition: cooperation in the sense that their relationship is based on mutual dependency, need and benefit; and competitive from the perspective of bargaining and the potential conflicts that may arise as a result of their conflict of interests and incompatible goals (Luo 2010). The cooperative aspect of the investor-state relationship falls out of the scope of the dispute resolution and it is the competitive feature that demands challenge and legal analysis.

Bargaining, as a method of competition, is the process of resolution of conflict of interests "through which each party tries to maximize its gains and minimize its losses" (Bachrach and Lawler 1981, ix). Thus when players intend to cooperate and they have conflict of interest, they bargain in order to resolve these conflicts.

More importantly they bargain in order to define the scope of the terms, rights, and duties. It is worth noting that "Some rights are formalized in law or agreement. Other rights are socially accepted standards of behavior, such as reciprocity, precedent, equality, and seniority."(Ury, Brett and Goldberg 1988, 7) Those rights formalised in law or those that are socially accepted standards of behavior are out of the control of the parties. Nonetheless the parties themselves determine some rights in the agreement by bargaining and consequently the agreement becomes their law.[20] Therefore the bargaining phase is the 'formation of law phase'.

[20] Generally based on the civil law system the contract is the law of the parties. French civil Code Article 1134 states: "Agreements lawfully entered into take the place of the law for those who have made them. They may be revoked only by mutual consent, or for causes authorized by law. They must be performed in good faith." Translated by Georges Rouhette, with the assistance of Dr Anne Rouhette-Berton, www.legifrance.gouv.fr/content/download/1950/.../3/.../Code_22.pdf

Bargaining in investment can be through two channels. BITs are products of inter-state bargaining, and investment contracts (or state contracts) are the result of direct bargaining between investors and host states.

In BITs, home states – particularly those states that are more capital exporting than capital importing – bargain with host states in order to protect their nationals, and host states bargain for sustainable development with less restrictive provisions on their regulatory power. The nature of each party's bargain is rooted in the objectives they pursue in forming a BIT. The objective of investors – on behalf of whom the home states negotiate – is to attain protection and a safe environment for investment. On the other hand the objective of host states is to promote capital flows and development of the country. In order to reach their objectives, the parties seek to shape the BIT in a way that best serves their interests. In the words of Ortino:

> "[T]he investment protection guarantees provided for in the body of the treaty are the instruments with which to encourage capital flows between the two countries and in turn contribute to the prosperity (or development) of both contracting parties. Accordingly, the object and purpose of a BIT cannot merely be the protection of foreign investments, as some tribunals have assumed." (Ortino, 2012, p. 5)

Generally, BITs consist of three core themes: definitions, rights, and duties. In the first place the parties provide definitions for the essential terms and concepts, and clarify the scope of the treaty. For instance in the US 2012 Model BIT, Article 1 provides a definition of the terms and Article 2 explains the scope and coverage of the treaty. The importance of bargaining in regards to the definition and scope section has consequential effects on the applicability of the treaty. By way of illustration, a treaty that defines the term 'investment' in a broad sense, limits the power of the host state by the protective rights that are covered by the treaty.

After the introductory part, the rights – and mainly the protective rights of the investors – are addressed. The core issues that home states bargain for in BITs are protective rights and dispute settlement through arbitration. National Treatment,[21] Most-favoured Nation Treatment,[22] Minimum Standard of Treatment including 'Fair and Equitable Treatment' and

[21] For instance, Article 3 of the US 2012 Model BIT
[22] For instance, Article 4 of the US 2012 Model BIT

'Full Protection and Security,'[23] Expropriation and Compensation,[24] are the most notable protective rights that home states seek to include in BITs. Furthermore, arbitration and most importantly arbitration via ICSID are the results of the superior bargaining power of home states (Allee and Peinhardt 2010). On the other hand it is more advantageous for the host state to convince the home state to agree on dispute resolution through national courts.

The third issue that is covered by BITs is the duties of the parties towards their countries and nation; environmental[25] and human rights[26] concerns are the most salient duties that oblige the states and investors to limit the scope of their performances. The aforementioned duties have led to incremental reforms in the BITs. One of the significant differences of the US 2012 Model BIT and the 2004 Model BIT is in regard to the duties, particularly human rights and the environment. The recent Model BIT put more emphasis on the importance of public aspects of investment, the environment and labour protections. For instance, to Article 12.3 of the 2004 Model BIT the following part has been added, which stipulates:

> "The Parties recognize that each Party retains the right to exercise discretion with respect to regulatory, compliance, investigatory, and prosecutorial matters, and to make decisions regarding the allocation of resources to enforcement with respect to other environmental matters determined to have higher priorities."[27]

Thus, definitions, protective rights, and duties are predominantly included in most of BITs. However, depending on the relative bargaining power of the parties, some clauses that

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"1. Each Party shall accord to investors of the other Party treatment no less favorable than that it accords, in like circumstances, to investors of any non-Party with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments in its territory.
2. Each Party shall accord to covered investments treatment no less favorable than that it accords, in like circumstances, to investments in its territory of investors of any non-Party with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments."

[23] Article 5 of the US 2012 Model BIT: "1. Each Party shall accord to covered investments treatment in accordance with customary international law, including fair and equitable treatment and full protection and security."

[24] Article 6 of the US 2012 Model BIT: "1. Neither Party may expropriate or nationalize a covered investment either directly or indirectly through measures equivalent to expropriation or nationalization ("expropriation"), except:
(a) for a public purpose;
(b) in a non-discriminatory manner;
(c) on payment of prompt, adequate, and effective compensation; and
(d) in accordance with due process of law and Article 5 [Minimum Standard of Treatment] (1) through (3)."

[25] For instance, Article 12 of the US 2012 Model BIT

[26] For instance, Article 13 of the US 2012 Model BIT

[27] Further duties that are often imposed on the BIT parties are transparency (Article 11 of the US 2012 Model BIT) and publication of the Laws (Article 10 of the US 2012 Model BIT).

provide excessive protection may be incorporated into a BIT. Salient examples of these are the umbrella clauses; these clauses extend the scope of the protection of investors. Under the umbrella clauses, the BIT covers the breach of contractual liabilities of the states and therefore the investor can benefit from the protective rights underlined in that BIT(Subedi 2008). In this case breach of contract by the state constitutes breach of the BIT and therefore is considered as an international breach. For instance, according to Article 3.5 of the BIT between the Netherlands and Poland:

> "Each Contracting Party shall observe any obligations it may have entered into with regard to investments of investors of the other Contracting Party."

In light of this clause the tribunal in *Eureko B.V. v Poland* held that:

> "A clause of such substance is often called "the umbrella clause". Thus, insofar as the Government of Poland has entered into obligations vis-à-vis Eureko with regard to the latter's investments, and insofar as the Tribunal has found that the Respondent has acted in breach of those obligations, it stands, *prima facie,* in violation of Article 3.5 of the Treaty" (*Eureko B.V. v Poland,* 2005, para. 244).

Therefore umbrella clauses are powerful protective mechanisms for investors. Notwithstanding umbrella clauses are products of bargaining power of the state parties. Therefore as BITs are usually between developed and developing countries, the hegemonic power of the states is determinant in the inclusion of umbrella clauses and more generally the formation of BITs. As it is noted in regard to the US BITs, "…A BIT negotiation is not a discussion between sovereign equals. It is more like an intensive training seminar conducted by the United States, on what it would take to comply with the U.S. draft."[28]

Investment contracts, as opposed to BITs, are generally negotiated and drafted behind closed doors and it is no easy task to explore their content. It might be claimed that indeed the states use their sovereign power to dominate the private investors. Conversely, "As a matter of self-interest, multinational corporations will use their economic power in bargaining to extract concessions from governments on such matters as protection, tax rebates, investment allowances, choice of factory sites and access to resources" (Leonard 1980, 456). Tantamount

[28] JE Alvarez's remarks made as Chairman of a panel at the ASIL annual meeting in 1992: *Proceeding of the ASIL 86th Annual Meeting,* 1992, 552-553, cited in Subedi, S. P. (2008). *International Investment Law.* Portland, USA: Hart Publishing, P. 85.

to BITs, some clauses may be exerted in investment contracts in order to provide excessive protection for the investors. The stabilisation clause is a paradigm for this type of clause in investment contracts and provides exclusive protective rights to the investors. Stabilisation clauses freeze the legal regime of the host state and the law that is applicable at the time of the conclusion of investment contracts. Stabilization clauses are generally in investment contracts and are different from the protections in BITS.[29] "Under BIT a host state is not prevented from taking new legal and administrative measures in accordance with the wishes of the people of the country or in order to comply with or implement the obligations flowing from an international treaty, whether dealing with human rights or environment matters" (Subedi 2008, 104). Stabilisation clauses "have the effect of preventing host states from enacting new legislation or undertaking new international obligations which would affect the profitability of the relevant foreign investors"(Subedi 2008, 104).

On the one hand, stabilisation clauses are mechanisms for enhancing the stability for investors, and thus attracting investment. On the other hand, stabilisation clauses have a chilling effect on the regulatory power of the host states (Subedi 2008). For now it suffices to conclude that stabilisation clauses are considered as the results of the weaker bargaining power of the host states (and especially unstable countries) in order to attract foreign investment,[30] and the regulatory chilling effect on the process of investment will be discussed in further detail in the following part.

Thus the content of BITs and investment contracts are predominantly determined by the bargaining power of the parties. "Power is the essence of bargaining"(Bachrach and Lawler 1981, 43); it eclipses the whole process and outcome of bargaining. The power that is used at the bargaining stage is called bargaining power and merits further examination. The notion of bargaining power and different types of power that are used in the bargaining stage will now be explored.

[29] Unless the treaty contains a stabilisation clause itself.
[30] In this respect, it is noteworthy that "the bargaining power of governments versus MNEs is changing in favour of the latter and that governments now come under pressure to be more cooperative with MNEs if they want increased FDI inflows" (Luo, 2010, p. 759).

II. Bargaining Power

The process of foreign investment is a bilateral monopoly. Monopoly is the highest degree of power that is exclusively possessed by one party. The extent that parties benefit from their monopolies depends on their bargaining power. Therefore bargaining power is a crucial factor in the formation, performance, and termination of foreign investment operations.

In foreign investment, on the one hand, the host state controls access to resources, taxation and expropriation; on the other hand investors have control over the operation of investment (Moran 1978). These controls confer power to each party. The main issue is the extent to which each player possesses power. In order to systematically study the relative power of the parties in investment, it is essential to explore a pertinent theoretical framework. Therefore a brief analysis of the concept of bargaining power and different forms of it must be pointed out at the outset.

Bargaining power is the overall power of the parties in the negotiation stage; the power that the parties possess in the preliminary stages of the formation of contract, which is also a determinant factor in the resolution of conflicts. A conflict that reaches the resolution phase has its roots mainly in the formation of investment agreements – in its general sense that includes investment treaties between states and investment contracts between investors and host states. Furthermore agreements are, in effect, the product of negotiation and bargaining. Power is a principal element of bargaining. Therefore "Bargaining power pervades all aspects of bargaining and is the key to an integrative analysis of context, process, and outcome" (Bachrach and Lawler 1981, 43).

In the bargaining stage of an investment, the parties generally use their political and economic power in order to define the scope of their legal power. Therefore it is essential to determine the political and economic power of host states and investors. Here the aim is to identify the power of the parties in the bargaining phase. As examined in chapter 1 the parties have different types of power; it is the degree of these powers that varies from one player to the other and from one relationship to the other. Thus for each player both their political and economic powers will be identified.

Political Power of Host States. [31] The host state, as discussed in the first chapter, plays an economic function in investment; however it is plausible that it exercises political power in order to redress any lack of economic powers. At a national level, *legislation* is a prevalent and effective political means for the state to regularise and control investment activities in the country. Regulations and laws that the state enacts can constrain power of the investors. For instance the host state can exert political power by regulating or amending the taxation law, laws in relation to environmental pollution, human rights and investment laws in general. Furthermore the state has sovereignty over its territory and all the resources within that territory. The host state has the right to ban any access to resources through investment by non-nationals. Thus the sovereign power[32] is a strong power that states have over their territory and activities in their territory.

At the international level, the state can wield political power through ratification of conventions and treaties. In the field of foreign investment, BITs are particularly crucial in determining the relative power of the host states. The more the power of a host state, the more is the chance to enact a treaty or convention with terms in favour of that state. For instance, when a host state is powerful and the investor is dependent on it, the host state is able to obtain pro-state terms in the treaties and conventions such as the settlement of disputes in the national courts. In effect in this case the political power of the state determines the degree of its bargaining power in gaining advantageous terms. Put another way, the political power of the host state determines the scope of its legal power.

Coercion is a fundamental issue that underlies the concept of political power. Coercion is a formal type of political power and it is a matter of degree. Military power, as a subcategory of political power, is the paradigm of force, which is the most observable and coercive form of power. Notwithstanding political power may be latent through inducement and manipulation.

As the investment operations are generally planned for the long term, investors need a degree of stability in order to organise their investments. Political stability of the host state is an essential factor that affects an investor's decision in commencing investment operations in that state. Higher stability facilitates investment and cooperation between the parties; on the

[31] Although in BITs negotiations are between home states and host states, the focus of this research is on the latter; the role of home states is not underlined as they only act on behalf of their investors.
[32] Or as it is sometimes called 'police power'

other hand low stability constrains an investor's confidence, increases investment costs and leads to lower cooperation with the host state (Luo 2010). Thus political stability of the host state can be considered as a subtle element that enhances the bargaining power of the state. To illustrate the effect of political stability on investment relationships, the current situation in Iran serves as a pertinent example. The sanctions and embargoes against the Iranian petroleum industry have shifted the power towards the investors – mainly China – to determine the terms which are in their benefit. In this situation, as there is no competition among the investors, there is no alternative source of supply – or they are scarce. Thus based on dependency theory,[33] Iran is compelled to accept any agreement to be able to maintain investment operations in the country. Hence the political instability of Iranian government in international relationships has resulted in a relatively weak position of this country in its investment relationships.

Consequently, although political instability is not favourable for investment operations, it can be considered as a potential for increasing investors' bargaining power with the host state to redress the degree of their risk.

The resistance of investors to the political power of states is by virtue of the political risk arrangements. Political risks are broadly defined as:

> "the probability of disruption of the operations of MNEs by political forces or events, whether they occur in the host countries, home country, or result from changes in the international environment. In the host countries, political risk is largely determined by uncertainty over the actions of governments and political institutions, but also of minority groups, such as separatist movements. In home countries, political risk may stem from political actions directly aimed at investment destinations, such as sanctions, or from policies that restrict outward investment" (World Investment and Political Risk (MIGA) 2010).

In a narrow sense, political risks are concerned with the risks in the host state and entail "breach of contract by governments, restrictions on currency transfer and convertibility, expropriation, political violence (war, civil disturbance and terrorism), non-honouring of government guarantees, adverse regulatory changes, and restrictions on FDI outflows in home countries" (World Investment and Political Risk (MIGA) 2010).

[33] Dependency theory is an appropriate framework for assessing the relative power of the parties and will be examined in the following section.

Political risks are classified by the insurance industry in order to provide protection and safeguard investors. The main categories of political risks recognised by most of the insurers are in an array of "(i) currency convertibility and transfer, (ii) expropriation, (iii) political violence, (iv) breach of contract by a host government, and (v) the non-honoring of sovereign financial obligations" (World Investment and Political Risk (MIGA) 2010). Some of these risks are unexpected political events and some are deliberately performed by states to coerce investors.

Economic Power of Host States. The reasoning behind attracting international investment is the need to develop the wealth, prosperity and economic situation of the country, which is not possible or is difficult for a developing state to perform itself, primarily because of the lack of economic power such as capital. However, even host states possess economic power and not all host states are economically weak. Some host states, mainly those with natural resources such as oil and gas, promote investment because of their need for technology and know-how in order to exploit their resources.

The economic power of the host state is latent and can be exerted in the form of manipulation and inducement. The strength of economic power of the host state and the effectiveness of manipulation and inducement via this type of power, hinge on the value of the resources that the host state possesses, the availability of those resources, and competition among the investors in the market. This analogy is based on the dependency theory, according to which the *availability* and *value* of the resources are two main factors in determining the power of one actor over the other. Host states with valuable resources are in a dominant position, at least in some stages of investment operations. This is due to investors' dependency on the host states' resources. For instance petroleum resources as valuable products, which are available to relatively few countries around the world, confer economic power to the countries with these resources.

Economic Power of Investors. The substantive type of power of the investors is concentrated largely on economic power. Investors possess capital, technology, know-how and generally all the rights with economic value in regards to operation of investment. The central reasoning behind the rise of foreign investment is the need of host states to access the special expertise, skill, and technologies possessed by investors, which are not available to local entrepreneurs. The dependency of host states on investors' knowledge confers substantial power to investors to the extent that they exploit host states (Moran 1978, 81).

Moreover their massive economic power has led some to go further and claim that MNEs are the single pole of power and that sovereignty of states is at bay (Kobrin 2009).

The economic power of MNEs bestows latent power on them to manipulate through their excessive power. As Lukes asserts, latent power is the most influential power (Lukes, 2005); thus it can be claimed that other types of investors' powers originate from their economic power. For instance, through their economic power and their impact on the economics of their home country, MNEs can influence states – mostly home states – to fill the political, administrative and judicial gap and regulate laws that can best benefit investors.

Political Power of Investors. The core power of MNEs lies in their economic power; however, as a result of their economic power, MNEs can acquire political influence over states and mainly their home states. It is the natural effect of power that having a particular type of power gives the possessor the power to achieve other types of power. It is worth emphasising that the origin of MNEs' political power lies in their economic power, as without having economic power they would not be able to exert political influence. The more their economic power, the more MNEs can gain political power, and the more they can influence and lobby the states, the more their needs and requirements will be respected and complied with by the states.[34]

MNEs can operate political functions indirectly by lobbying with their home states.[35] In fact a remarkable influence of MNEs over the states is through lobbying in the rule-making process. The economic power of MNEs empowers them to dictate to their home states, the rules that are favourable for their companies. Although it is an extremist ideological and Marxist oriented perspective to believe that always "rules follow power and that power, more often than not, clusters around wealth," occasionally in practice this may turn out to be the case.(Spar 2010, 217). In this respect, an example of a Multinational Fruit Company illustrates the political power of these MNEs:

> "For years, UFC [United Fruit Company] was an indomitable force throughout the banana-producing world. It wrote the rules that met its needs and enforced them through local alliances and the strong arm of US diplomacy. So great was the

[34] It is worth noting that the political power of investors depends on their economic power and therefore in this respect an individual investor, although possessing economic power, is not equal to a company, and a small or medium sized company is not equal to a giant MNE.

[35] Investors can also lobby with host states, which then brings up the issue of corruption of the host state. This is beyond the context of this thesis.

company's power that it gave rise to the term 'banana republic' – an apt description for most of the region in which UFC held sway" (Spar 2010, 218).

The political power of investors is particularly relevant with regard to large-scale investments such as those of the petroleum sector, where the investment has a great impact on the capital-importing as well as capital-exporting countries. However "So long as nation-states can intermediate in this struggle, they are likely to remain influential actors in the world of international business, shaping the rules that firms follow and the environment in which they compete" (Spar 2010, 221).

Apart from the influence of MNEs over political issues, they can benefit from other support of the home states. This claim is particularly true with regard to the powerful home states such as the US and European countries (Kline, 2006). In this respect it has been stated that, "although instances have occurred in which MNEs appeared to thwart state opposition, such events typically involved overt or covert support from the political, economic or sometimes military influence of the MNCs' powerful home government" (Kline 2006-2007, 125). Usually, states support the most powerful economic actors. "There often exists a strong alliance between the foreign corporation and various powerful home state groups such as landowners, or other pro-business conservative groups" (Tarzi, 2000, p. 163). The reason is claimed to be the mutual benefit of the states and economic actors, particularly the powerful companies:

> "first, they are necessary if a national economy is to experience sustained economic growth; second, they lend themselves to supplying governments, through taxation, with the regular and relatively high volume of resources governments need to finance military expenditure and support other administrative activities" (Poggi, 2001, p. 145).

Thus, MNEs have political power and can play a significant role in the field of investment. However the degree of their power is essential in the effects they can have on the political affairs of both home and host states. As power – in general, all types of power – is relational and it varies from one relationship to the other, the measurement of the degree of MNEs' power in relation to states is a complex issue. As discussed in Chapter 1, part C, the dependency theory provides a framework to assess the relative bargaining power of the parties and generally power through the dependency of one party to the other. Accordingly, "Dependence can both define the bargaining relationship and analyze the variation that occurs

with bargaining relationships" (Bachrach and Lawler 1981, 79). However, the amount of power of the investment parties shall be measured on a case by case basis.

B. The Performance Phase

In the bargaining phase, investors and host states exercise their political and economic powers in order to define the scope of their rights, which are in fact their legal powers. In the performance phase, while operating the investment, investors and host states exercise the legal powers determined in the bargaining stage in order to attain their interests. As the investment parties have conflict of interests thus they may misuse[36] their power to redress their bad bargain and to reach their optimum interests.

One of the primary aims of the investment law system, including investment arbitration, is to control the misuse of power by the sovereign power of the host state. Nonetheless, as examined above, investors have power too and therefore there is always the risk of their misusing power. In other words, both the state and investors possess power and in their relationship there is always the risk of misuse of power by each of them.

The origin of exercising legal power and sometimes its misuse by investment parties is rooted in their conflict of interest: the conflict between public interests of host states and private interests of investors. Each party seeks to attain its interests, sometimes at the expense of the other party.

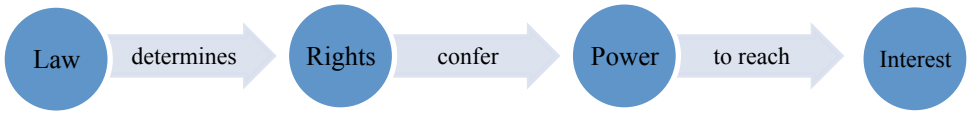
Therefore, this chapter explores the legal powers of the investment parties as well as the reason for which they exercise those powers: conflict of interests. The legal powers of states and investors will be identified at the outset. These powers are the rights that are conferred to the parties by the law. Then the public and private interests will be examined in order to explore the reasoning behind the exercise of power during the performance of investment. The regulatory power of states and the protective rights of the investors as the predominant interests of the investment parties will be underlined as the core of conflict of interest in investment relationship.

Notwithstanding, before examining the legal powers and conflict of interests in the international investment field, it is essential to elucidate the theoretical conceptions that underpin the discussion as well as the thread between them which will further illustrate the structure of discussion of the performance phase.

[36] Misuse of power can be conceptualised in terms of the use of power in an illegal or excessive way.

Legal power is interconnected with law, rights and interests. The *law* determines the *rights* of the parties; rights in one sense are power, or in other words, confer the power to exercise an act[37] and therefore are delineated as *legal powers*;[38] and powers are exercised in order to reach *interests* (see Figure 2).

Figure 2: The Interconnection between Law, Rights, Power, and Interests



Thus it can be conceived that the rights, interests, conflict and power of the investing parties are intertwined concepts. In order to illustrate the interaction between these concepts and their use in investment, their theoretical notion will be further explained. However it is worth noting that the aforementioned concepts are all complex and abstract and it is no easy task to provide a universal definition for them; here the attempt is to briefly elucidate their notion and relation in order to later discern their use in the theme of investment.

As examined in the 'Typology of Power' section of Chapter 1, Hohfeld conceptualises one type of rights as power, and thus that is named as the legal power in this study. Furthermore, Raz defines rights in terms of interests of the right holder.[39] He asserts that: "'X has a right' if and only if X can have rights, and, other things being equal, an aspect of X's well-being (his interest) is a sufficient reason for holding some other person(s) to be under a duty" (Raz, 1988, p. 167).[40] Thus according to this definition, rights are conceptualised as power and interests and thus are entwined concepts.

Power is a means by which one may reach one's interests, or in the case of conflict of interests, resolve the disagreements.[41] Power, at least in one sense, is conceptualised in terms of "the conflicting interests and goals of the participants and the abilities of some to secure

[37] See Chapter 1 on Hohfeld's conceptualisation of rights as power.
[38] See Chapter 1 on 'Typology of Power'
[39] Generally there are two predominant schools of thought on the concept of rights: interest theory and will theory. According to the interest-based theory, rights protect the interests of the rights holder (Raz, The Morality of Freedom, 1988). Based on the will theory, rights protect the choice and will of the right holder (Hart, 1983). In this study the former theory (the interest theory) is pertinent and will be applied.
[40] This definition of right is based on the interest theory.
[41] The notion and different theories of power are thoroughly analysed in Chapter 1. Here the aim is to merely show its relation to the above-mentioned concepts.

the compliance of others" (Lukes, 2005, p. 7). One of the renowned theories of power that explains power in terms of conflict of interests is Lukes' three-dimensional power. Recall that according to this theory power exists merely in the relations of conflict of interests.

Interest – such as other social concepts, for instance power – is a multifaceted concept(Benditt 1975)(Plamenatz 1954). Despite the vague notion of interests, one may define this term as follows: "Interests are needs, desires, concerns, fears – the things one cares about or wants."(Ury, Brett and Goldberg 1988, 5). They are "goals, values, desires, expectations, and other orientations and indications that lead a person to act in one way rather than other"(Morgan 2006). Interest is relational; the interest of one party may collide with the interest of the other and therefore conflict of interests arises. Conflict of interests – as discussed in the 'Conflict' part of Chapter 1 – is a cause of dispute or overt conflict.

Therefore, it can be concluded that interests are what one wants and acts for, rights protects these desires, and power is a means to reach these wants – or to resolve the conflict between interests. In international investment, investors have private interests and host states have public interests;[42] their rights and legal powers protect these interests and enable them to reach these interests.

To put it differently, the law in the investment relationship consists of the regulations, conventions, Multilateral Investment Treaties, BITs, and contracts. These legal instruments define the nature and scope of the rights of the parties. The bargaining phase, as examined in the previous part, is the formation of the law, negotiation and determination of rights of the parties. In the performance of investment phase, the investment parties as actors with conflict of interests use their powers to further their interests and goals. Each party enters the investment relationship to pursue interests, and seeks to reach those interests through different powers and rights that it possesses. The ability to reach these interests is mainly contingent on the power dynamics, and particularly legal powers.

[42] "[T]he public is the collective interests of a host State, and the private is the individual interest of an investor company in protecting, and profiting from, its capital" (Mills, 2011, p. 488).

I. Legal Power of the Parties

The legal power of the host state lies in the rights that are enacted in the laws and regulations. At the national level, the provisions of national laws, such as investment laws, taxation laws, human rights and environmental regulations, confer rights to the state in a more specific and detailed manner that can be utilised as legal powers against investors.

More importantly the rights that are predicted in the international documents, particularly BITs as well as international conventions empower the host state. One of the principal legal powers of host states is their right to nationalise or expropriate – subject to public purpose, due process of law and with adequate, prompt and effective compensation. Expropriation is a lawful right of the states and endows them with the power to take property within their territory and it is recognised in different legal documents such as conventions and BITs.[43] "Expropriation is therefore lawful."(McLachlan, Shore and Weiniger 2007, 267)

As Brownlie asserts

> "state measures, prima facie a lawful exercise of powers of governments, may affect foreign interests considerably without amounting to expropriation. Thus, foreign assets and their use may be subjected to taxation, trade restrictions involving licenses and quotas, or measures of devaluation. While special facts may alter cases, in principle such measures are not unlawful and do not constitute expropriation" (Brownlie, 2008).

Therefore the state can apply its sovereign power within its territory to affect foreign investment and the balance of power with investors. These measures, as mentioned by Brownlie, are not unlawful; they are rights that states possess, which consequently confer them power.

A further right of host states is their inherent right, which is "in accordance with the general principles of international law, the right to pursue their own development objectives and priorities" (IISD Model International Agreement on Investment for Sustainable

[43] For instance in the United Nations Code of Conduct on Transnational Corporations it is articulated: "In the exercise of their sovereignty, States have the right to nationalize or expropriate foreign-owned property in their territory. Any such taking of property whether direct or indirect, consistent with international law, must be non-discriminatory, for a public purpose, in accordance with due process of law, and not be in violation of specific undertakings to the contrary by contract or other agreement; and be accompanied by the payment of prompt, adequate and effective compensation."

Development, 2005, Article 25.1). To clarify the concept of inherent rights of the host states, it is worth considering the United Nations Charter of Economic Rights and Duties of States (1974). According to Article 2 (1) of the Charter, "Every State has and shall freely exercise full permanent sovereignty, including possession, use and disposal, over all its wealth, natural resources and economic activities." (United Nations Charter of Economic Rights and Duties of States, 1974, Article 2.1) Therefore the Charter recognizes the political sovereign power of host states in controlling the access to their territory and resources. Furthermore the right to regulate and exercise of authority over foreign investment (Article 2.2.a), the right to supervise the activities of transnational corporations (Article 2.2.b), and the right to nationalize, expropriate and transfer of ownership (Article 2.2.c), are expressly stipulated in the Charter. These rights along with general rights of states to engage in the economic development of their countries are considered as inherent powers of the state.

As for the legal powers of investors, it must be noted that one of the objectives of foreign investment law lies in the protection of investors against host states. The protection of foreign investors is principally in the form of rights conferred to them mainly by BITs. MNEs, as the principal investors, are legal persons and according to the general rules of corporations, legal persons can have all the rights that individuals have, except for those rights that only individuals can possess as a state of their nature such as parental rights. Apart from the inherent rights of legal persons, MNEs – and more generally investors – are conferred special rights in order to be protected against sovereign power of states. These rights are originated from international law and are mostly drafted in investment treaties (Bilateral and Multilateral Investment Treaties) and investment agreements. Investment treaties particularly legalise the protection of investors by determining some rights for them. In the words of Wallace:

> "The frequency and magnitude of transboundary operations in private direct investment carried out by such enterprises [MNEs], and the resultant effects on the international flow of capital, materials, goods and technology, have caused academics as well as political and legal observers to regard this type of corporate entity as falling within the scope of international law and, concurrently, as possessing certain rights and duties under international law" (Wallace 2002, 9).

The rights that investors have in regard to their role in the host state territory confer them excessive power, and as they are incorporated in investment treaties, investment

contracts, international regulations and conventions, they are considered as legal powers.[44] The legal power of investors can be divided into two categories of rights: substantive and procedural (Franck S. D., 2007).

Substantive rights of investors are in an array of investment protection rights and can be classified as standard of fair and equitable treatment, full protection security, national treatment, most favoured nation treatment, and non-discrimination (*Occidental v Ecuador,* 2004). These rights are broad legal concepts and are subject to interpretation by arbitrators. In other words, in each particular case, arbitrators shall interpret the scope and applicability of the relevant right, and decide whether that right is breached.

The most prominent procedural right of investors is the direct access to *arbitration* in resolving their conflicts with the host states. The purpose of the latter right of investors was initially to redress their inequalities with host states (Franck S. D., 2007). Thus based on this approach on investment arbitration, a paradoxical argument can be raised that arbitration, which is assumed to be a neutral and independent dispute resolution mechanism, is in fact a

[44] For instance the North American Free Trade Agreement (NAFTA) in Chapter 11 Section A articulates the rights of the investors in the following Articles:
Article 1102: National Treatment 1. Each Party shall accord to investors of another Party treatment no less favorable than that it accords, in like circumstances, to its own investors with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments. 2. Each Party shall accord to investments of investors of another Party treatment no less favorable than that it accords, in like circumstances, to investments of its own investors with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments. 3. The treatment accorded by a Party under paragraphs 1 and 2 means, with respect to a state or province, treatment no less favorable than the most favorable treatment accorded, in like circumstances, by that state or province to investors, and to investments of investors, of the Party of which it forms a part. 4. For greater certainty, no Party may: (a) impose on an investor of another Party a requirement that a minimum level of equity in an enterprise in the territory of the Party be held by its nationals, other than nominal qualifying shares for directors or incorporators of corporations; or (b) require an investor of another Party, by reason of its nationality, to sell or otherwise dispose of an investment in the territory of the Party.
Article 1103: Most-Favored-Nation Treatment 1. Each Party shall accord to investors of another Party treatment no less favorable than that it accords, in like circumstances, to investors of any other Party or of a non-Party with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments. 2. Each Party shall accord to investments of investors of another Party treatment no less favorable than that it accords, in like circumstances, to investments of investors of any other Party or of a non-Party with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments.
Article 1104: Standard of Treatment Each Party shall accord to investors of another Party and to investments of investors of another Party the better of the treatment required by Articles 1102 and 1103.
Article 1105: Minimum Standard of Treatment 1. Each Party shall accord to investments of investors of another Party treatment in accordance with international law, including fair and equitable treatment and full protection and security. 2. Without prejudice to paragraph 1 and notwithstanding Article 1108(7)(b), each Party shall accord to investors of another Party, and to investments of investors of another Party, non-discriminatory treatment with respect to measures it adopts or maintains relating to losses suffered by investments in its territory owing to armed conflict or civil strife. 3. Paragraph 2 does not apply to existing measures relating to subsidies or grants that would be inconsistent with Article 1102 but for Article 1108(7)(b).

power in the hands of one of the parties; therefore one may claim that the essence of arbitration is fundamentally biased in favour of investors. Accordingly any agreement between the parties to settle disputes by arbitration, could be regarded as an imposition of power over the host state party. This analysis results in considering investment arbitration as a tool for the investor by virtue of which it is possible to shift the balance of power towards investors. Thus disregarding the outcome, the nature of arbitration is essentially pro-investor. To put it another way, by convincing the host states to resolve investment disputes through arbitration, investors are one step ahead of host states in exercising their legal power. However the plausibility of accomplishing this goal centres primarily on the bargaining power of investors.

Conversely, at the other end of the spectrum it has been argued that arbitration prevents any abuse of power by states but by no means operates pro-investor. The reason the conflicting parties, particularly the host state, adhere to investment arbitration is "because this legal framework, including the potential for highly enforceable investment awards, creates a positive investment climate that attracts foreign investment that is beneficial to the economy of recipient States" (Reinisch, 2009, p. 900). Therefore, Arbitration is a tool that balances the interests of the investors and host states.

Regarding the widespread use of arbitration, the latter view is an orthodox view; nonetheless this is contingent to the fact that arbitration remains within its original boundaries defined by the rule of law: impartiality and independency of arbitrators, equality before the law and the arbitral tribunal and procedural fairness. The rule of law is a sufficiently crucial topic to deserve a chapter on its own and will be discussed in Chapter 4. To sum up, although its essence is advantageous to investors, arbitration is (or at least for the legitimacy and effectiveness of the system, ought to be) a means that aims at balancing the conflict of interests between the parties. Before exploring the role of arbitrators in regard to the power and interests of the parties, the conflict of interests between them will now be elucidated.

II. Public *v.* Private Interests

In the Investment Policy Framework for Sustainable Development drafted by the UNCTAD in 2012, the right to regulate has been mentioned as one of the core principles for investment policymaking for sustainable development (United Nations Conference on Trade and Development, Investment Policy Framework for Sustainable Development, in World Investment report Chapter IV, 2012, p. 109).

A crucial challenge to the international investment system is the underlying role of host states in protection of the society in parallel to their function as a treaty party to protect the investors in their territories(Spears 2010). In other words, the concern is based on the public interests of host states and the private interests of investors. Host states have the right to regulate in order to protect their public interests, particularly in regard to environmental and human rights issues, and investors have the right to rely on the provisions of the IIAs in order to protect their private interests in respect to safe and secure investment. Therefore the investment parties have different interests that may be in conflict. The rights of investors and host states confer on them legal power to attain and resolve their conflict of interests.

Generally the public interests of capital-exporting countries are to protect their investors in the relationship with host states; in other words the private interests of investors coincide with the public interests of their home states (Mills, 2011). In negotiating BITs equal obligations for capital-importing and capital-exporting countries – particularly when the former is in a weaker position and more dependent on the latter – are at the advantage of capital-exporting countries. Thus the real conflict between private and public interests is between host states and investors. However it is worth emphasising that the traditional division between capital-importing and capital-exporting countries is blurred, as many capital-exporting countries such as the US are at the same time capital importing and are therefore affected by the provisions of BITs, furthermore. In other words, BITs are becoming genuine *bilateral* – not unilateral – documents of obligation. “In general in circumstances of bilateral capital flows, both states contemplating a BIT must themselves strike a balance between their public interest in maintaining regulatory freedom and the interests of their investors (or their indirect interest in maximizing the profits of their investors) in determining their negotiating position” (Mills, 2011, p. 490).

In practice the conflict between the private and public interests of the parties has been one of the main causes of dispute between investors and host states.[45] The recourse to the private interests of investors as 'causes of action' and the public interests of host states as 'defences to responsibility', shape the major part of the disputes in international investment (Sornarajah, 2010). Accordingly, the 'taking of property' and the 'violation of international minimum standard of treatment' constitute the causes of action against the host states in investment arbitration (Sornarajah, 2010).

The investors' interest is to sustain "stability and predictability of the business environment, founded on solemn legal and contractual commitments" (*CMS Gas Transmission Company v The Argentine Republic,* 2005, para 284). They expect the situation at the time of initiation of investment to stay the same throughout the process of investment. Thus whenever the situation is not compatible with their legitimate expectations, they claim compensation based on the violation of "national treatment, fair and equitable treatment and full protection and security, prohibition of arbitrary or discriminatory measures and expropriation" (*Occidental v Ecuador,* 2004). On the basis of the so called 'legitimate expectations' many arbitral tribunals have made decisions in favour of investors.[46] For instance the tribunal in *Tecmed v Mexico* held that:

> "The Arbitral Tribunal considers that this provision of the Agreement, in light of the good faith principle established by international law, requires the Contracting Parties to provide to international investments treatment that does not affect the basic expectations that were taken into account by the foreign investor to make the investment. The foreign investor expects the host State to act in a consistent manner, free from ambiguity and totally transparently in its relations with the foreign investor, so that it may know beforehand any and all rules and regulations that will govern its investments, as well as the goals of the relevant policies and administrative practices or directives, to be able to plan its investment and comply with such regulations." *(Tecmed v United Mexican States*, 2003, para 154)

[45] In many Argentinian cases: *Occidental v Ecuador, Aguas del Tunari S.A. v Bolivia, Azurix Corp v Argentina, Biwater Gauff v Tanzania, Piero Foresti, Laura de Carli and Others v Republic of South Africa, Vattenfall et al v Federal Republic of Germany, Ethyl Corp v Canada, Metalclad v Mexico, S.D. Myers v Canada, Grand River Enterp Six Nations v United States, Glamis Gold v US, EDF v Romania, SGS v Philippines, Lemire v Ukraine, Saluka v Czeck Republic*

[46] For instance, *Tecmed v Mexico* (2006) 10 ICSID Reporters 54, *Sempra Energy International v Argentina* ICSID Case No ARB/03/29 (2005).

This wide and pro-investor interpretation of 'legitimate expectations' is based on the *subjective* interests of the investors (Mills, 2011). It can result in regulatory chill, undermining the regulatory power of the host state, and consequently its public interests.

On the other hand, states have the inherent right to regulate the domestic affairs of their countries in order to protect their nation. *(Lemire v Ukraine,* 2010, para 283) The legitimate expectation of the investors in regard to their private interests must not impede the regulatory power of host states.

> "The idea that legitimate expectations, and therefore FET [fair and equitable treatment], imply the stability of the legal and business framework, may not be correct if stated in an overly-broad and unqualified formulation. The FET might then mean the virtual freezing of the legal regulation of economic activities, in contrast with the State's normal regulatory power and the evolutionary character of economic life. Except where specific promises or representations are made by the State to the investor, the latter may not rely on a bilateral investment treaty as a kind of insurance policy against the risk of any changes in the host State's legal and economic framework. Such expectation would be neither legitimate nor reasonable." (*EDF (Services) Ltd v Romania*, 2009, para 217)

It is essential for the host states to consider their public interests particularly in respect to the fundamental aspects of their society such as health, security, labour and human rights. In light of this line of arguments the legitimate expectations of the investors should be evaluated *objectively* by emphasising on the right of states to regulate and to protect their public interests (Mills, 2011).

Thus it can be perceived that the scope of the protective rights of investors is contingent on the regulatory space of the state (Mills, 2011), and the public interests of host states may be in conflict with the private interests of investors. Nonetheless it is necessary to maintain balance between the interests of the parties. The importance of the balance between the public and private interests of the parties in investment relationships has had consequences on the whole system. In this respect, different actions are undertaken in order balance and therefore increase the legitimacy of the system. Some countries such as the US and South Africa have initiated fundamental reviews of their BITs. In 2012 the US reviewed

its 2004 Model BIT in order to enhance the consistency of the model BIT "with the public interest and the overall U.S. economic agenda."[47]

> "Like the predecessor 2004 model BIT, the 2012 model BIT continues to provide strong investor protections and preserve the government's ability to regulate in the public interest. The Administration made several important changes to the BIT text so as to enhance transparency and public participation; sharpen the disciplines that address preferential treatment to state-owned enterprises, including the distortions created by certain indigenous innovation policies; and strengthen protections relating to labor and the environment."[48]

As for South African reviews of BITs, the Department of Trade and Industry issued a report asserting that: "Existing international investment agreements are based on a 50-year-old model that remains focused on the interests of investors from developed countries. Major issues of concern for developing countries are not being addressed in the BIT negotiating processes." (Vis-Dunbar, Damon, Investment Treaty News, 2009)

A further strategy in line with the inadequacy of the current investment system in responding to public interests of host states is the denunciation of states from the ICSID Convention. In 2007 the Republic of Bolivia declared its withdrawal from ICSID under Article 71 of the Convention.[49]

Eventually, as a result of structural changes in the international investment system – the underlying role of the developing countries in exporting capital, and developed countries as recipients of investment – and the challenges of "the need to strengthen the development dimension of international investment agreements (IIAs), balance the rights and obligations of states and investors, and manage the systemic complexity of the IIA regime" (United Nations Conference on Trade and Development, Investment Policy Framework for Sustainable Development, in World Investment report Chapter IV, 2012, p. 97) a new trend

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[47] Federal Register Notice: Written Comments Concerning the Administration's Review of the U.S. Model Bilateral Investment Treaty, Department of State, Office of the United States Trade Representative, Public Notice 6693

[48] United States Concludes Review of Model Bilateral Investment Treaty, Media Note Office of the Spokesperson, Washington, DC, April 20, 2012, http://www.state.gov/r/pa/prs/ps/2012/04/188198.htm, accessed 9/11/2012

[49] Bolivia Submits A Notice Under Article 71 of the ICSID Convention: https://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=OpenPage&PageType=AnnouncementsFrame&FromPage=NewsReleases&pageName=Announcement3, Accessed 9/11/2012

known as the ‘new-generation of IIAs’ has emerged. The ““New generation” investment policies place inclusive growth and sustainable development at the heart of efforts to attract and benefit from investment.”(United Nations Conference on Trade and Development, Investment Policy Framework for Sustainable Development, in World Investment report Chapter IV, p. 102). For this purpose the UNCTAD has formulated the Investment Policy Framework for Sustainable Development (IPFSD) in order to face the current challenges of the investment system and to enhance its legitimacy and effectiveness.

> “the framework operates lucidly, putting particular emphasis on the relationship between foreign investment and sustainable development, advocating a balanced approach between the pursuit of purely economic growth objectives by means of investment liberalization and promotion, on the one hand, and the need to protect people and the environment on the other.” (Investment Treaty News, 2012)

Thus in light of the sustainable development objective, the private and public interests of the parties are impliedly addressed. It is worth noting the objective and notion of sustainable development in order to clarify its underlying role in regard to the interests of the parties:

> “the objective of sustainable development involves a comprehensive and integrated approach to economic, social and political processes, which aims at the sustainable use of natural resources of the Earth and the protection of the environment on which nature and human life as well as social and economic development depend and which seeks to realize the right of all human beings to an adequate living standard on the basis of their active, free and meaningful participation in development and in the fair distribution of benefits resulting therefrom, with due regard to the needs and interests of future generations.” (ILA New Delhi Declaration of Principles of International Law Relating to Sustainable Development, 2002, p.212)

The Framework consists of eleven core principles for policymaking: 1. Investment for sustainable development, 2. Policy coherence, 3. Public governance and institutions, 4. Dynamic policymaking, 5. Balancing rights and obligations, 6. Right to regulate, 7. Openness to investment, 8. Investment protection and treatment, 9. Investment promotion and facilitation, 10. Corporate governance and responsibility, 11. International cooperation. (United Nations Conference on Trade and Development, Investment Policy Framework for

Sustainable Development, in World Investment report Chapter IV, 2012, p. 107). Amongst the aforementioned principles, the balancing rights and obligations, is pertinent to the public and private interests of the parties and entails that "countries maintain sufficient policy space to regulate for the public good" (United Nations Conference on Trade and Development, Investment Policy Framework for Sustainable Development, in World Investment report Chapter IV, 2012, p. 109). Although the *investment protection*, and the *investment promotion and facilitation* principles highlight the importance of the interests of investors, the Framework stipulates that "countries should not compromise sustainable development goals, for instance by lowering regulatory standards on social or environmental issues, or by offering incentives that annul a large part of the economic benefit of the investment for the host country."(United Nations Conference on Trade and Development, Investment Policy Framework for Sustainable Development, in World Investment report Chapter IV, 2012, p. 109). Therefore the public interests of the investors and the private interests of the investors are two sides of one coin and one should not be undermined by the other. In Spears' words:

"By uniting and accommodating economic growth, social development and environmental protection under one umbrella, the concept of sustainable development can help reconcile the objectives of business and the rest of society, as well as of states at different levels of development" (Spears, 2010, p. 1070-1071).

The question that remains is of how to balance the public and private interests of the parties, particularly after a dispute arises and is in the resolution phase. The following chapter examines the role and power of arbitrators in regard to the power of the parties in general, and thus the issue of balancing the public and private interests of the investment parties as one of the functions of arbitrators will be delineated in detail.

CHAPTER 3: POWER IN THE ARBITRATION PHASE

The preceding chapter explored the role of power in the pre-arbitration phase. It attempted to elucidate the idea that conflicts are rooted in the exercise of power in the early stages of the formation and performance of an investment relationship. Therefore, although the main focus of this thesis is on the arbitration phase, the origin of power and conflict, as two essential elements of the thesis, is in the early phases of investment.

The impact of arbitrators' powers can be on substantive and procedural aspects of the conflict, and these two aspects are accordingly dealt with in the second and third parts of this chapter. The role of arbitrators on the substantive aspect of the conflict is with regard to the power of the parties in the formation (bargaining) and the performance phases of investment. In regard to the bargaining phase, arbitrators can address the inequality of bargaining power of the investment parties – which can be a cause of conflict – through their powers over the parties, and through pertinent principles such as the inequality of bargaining power doctrine. As for the performance of investment stage, the doctrine of proportionality confers on arbitrators the ability to control the imbalanced power of the parties in the performance of investment.

The role of arbitrators in regard to the procedural aspect of conflicts is in fact their role in respect to the power of the parties in the process of conflict resolution. The procedural dimension is formal and based on the main principles of the rule of law; impartiality and independency, equality before the law, and procedural justice are the principal requirements that arbitrators shall abide by in order to control the powers of the parties in regard to the procedural aspect of conflict.

This chapter is subdivided into three parts and proceeds to explore the role of power in the arbitration phase. First, the power of arbitrators and the sources from which they gain their powers will be delineated at the outset. The law, the parties, and inherent powers as the principal sources of arbitrators' powers and the powers that flow from each source will be discussed in this part. The aim of exploring the power of arbitrators is to firstly underline that arbitrators, like investment parties, have powers, and secondly the objective is to analyse the role of their powers on the powers of investment parties.

Thus, after illustrating different powers of the arbitrators, the power of arbitrators in regard to the substantive exercise of power will be explored in the second part of this chapter. As for the bargaining phase, inequality of bargaining power doctrine will be scrutinised by drawing an analogy to the role of judges particularly in the common law system in respect to inequality of bargaining power. Furthermore the role of arbitrators in dealing with conflict of interests between the private and public interests of the investors and host states during the process of investment will be described through 'balancing and proportionality' principles.

The third part of this chapter explores the role of arbitrators in regard to the procedural aspect of conflicts. The three principles of impartiality and independency, equality before the law, and procedural justice will be examined to highlight the influence of arbitrators on the power of the conflicting parties with respect to the procedural dimension of conflict.

A. Powers of Arbitrators in General

The power of arbitrators is crystallised in the conflict phase when the conflicting parties refer to an arbitral tribunal in order to resolve their conflicts. In arbitration proceedings, "The balance of power, in effect, shifts from the parties to the arbitral tribunal"(Redfern, et al. 2009, 315). To put it differently, arbitrators are delegated power in order to perform judicial functions. The duty for which arbitrators are empowered is to make decisions and resolve the conflicts between the parties. Thus power is an intrinsic element of the concept of arbitration.

The judicial authority of arbitrators is broad and is exercised in different stages of the arbitration process: formation of the arbitration agreement, arbitration procedure, decision-making, and enforcement of the award. In the formation stage the power of arbitrators is limited to the stage when they are appointed. The main power of arbitrators that can be exercised in the preliminary stage of arbitration is *competence de la competence*, which is the power to decide their own jurisdiction. Furthermore in some cases when the panel of arbitrators is formed of three arbitrators, under some Arbitration Rules such as UNCITRAL, the two arbitrators have to appoint the third arbitrator;[50] in these cases the two appointed arbitrators have the power to appoint the third arbitrator.

In the procedural stage the judicial power of arbitrators can be classified into two categories of 'filling the gaps' not determined by the parties and 'request of evidence'(Redfern, et al. 2009). According to the former, when the parties have not determined some issues such as the applicable law, the law of the seat, or the language of the arbitration, the arbitrators have the authority to decide the non-determined issues. As for evidence, arbitrators have the power to request presence of witnesses, appoint experts and administer oath in order to make decisions.

After the procedural stage arbitrators have the authority to make decisions by 'issuing awards'. Decision-making is one of the main or perhaps the main power of arbitrators. Along with issuing awards, arbitrators possess other powers in the stage of decision-making and enforcement of the award. Interpretation, revision and annulment of the award are powers that

[50] For instance UNCITRAL Arbitration Rules Article 9(1): "if three arbitrators are to be appointed, each party shall appoint one arbitrator. The two arbitrators thus appointed shall choose the third arbitrator who will act as the presiding arbitrator of the arbitral tribunal."

arbitrators possess based on some arbitration rules.[51] Thus the power of arbitrators is spread in different stages of arbitration. A brief introduction on the typology of arbitrators' power will be provided, and then the chapter will concentrate on the sources of arbitrators' powers.

The types of power that arbitrators possess can be examined from different perspectives. As set out in Chapter 1, on power, one way of classifying powers is based on formal and substantive powers. From the formal aspect of the typology of power, arbitrators' powers are *authority* and *expertise*. Recall from previous chapters that authority is a legitimate power conferred to a third party to make decisions on behalf of those that have conferred power. Arbitrators as neutral third parties have authority, conferred on them by the consent of the conflicting parties.

One of the main reasons the conflicting parties confer authority on the arbitrators to decide their case, is the arbitrators' *expertise* in the relevant field, which confers on them the power to make decisions. Based on the principle of party autonomy, the parties can determine the special skills and expertise that they require from the prospective arbitrator. Furthermore legal documents on arbitration may provide special provisions for the expertise of arbitrators.[52] Generally the expertise of arbitrators can vary depending on the field of the dispute, however "ordinary legal capacity is required in principle"(Gaillard and Savage 1999, 560). The expertise of arbitrators is a factor that increases their general power and credibility, particularly at the stage of the appointment of arbitrators; those arbitrators with greater expertise and experience have greater power and therefore have more chance of being appointed by the conflicting parties.

In terms of substantive power, arbitrators have *judicial power*. Judicial power, as a type of legal power, is the authority vested in judicial actors to make decisions in regard to conflict. The legal power vested in arbitrators is thus to *judge* and *make decisions* and therefore is a judicial power. "The judicial power is the principal characteristic of their [arbitrators'] role and enables arbitration to be distinguished from superficially similar

[51] For instance Section 5, Articles 50-53 of the ICSID Arbitration Rules is on Interpretation, Revision and Annulment of the award.

[52] For instance according to Article 14 of ICSID Arbitration Rules: "(1) Persons designated to serve on the Panels shall be persons of high moral character and recognized competence in the fields of law, commerce, industry or finance, who may be relied upon to exercise independent judgment. Competence in the field of law shall be of particular importance in the case of persons on the Panel of Arbitrators. (2) The Chairman, in designating persons to serve on the Panels, shall in addition pay due regard to the importance of assuring representation on the Panels of the principal legal systems of the world and of the main forms of economic activity."

concepts such as expert proceedings, conciliation and mediation"(Gaillard and Savage 1999, 560). In other words apart from judges that are paradigms of judicial power, arbitrators hold judicial power to resolve disputes by making binding decisions.

Along with their juridical power, arbitrators may also possess some forms of social power. The most important social power of arbitrators is their reputation and prestige. Arbitrators with good reputation and prestige have greater power in being appointed, in managing the process of arbitration, and in being respected by the parties as well as other professionals and arbitrators in that field. In addition to the reputation of individual arbitrators, arbitration institutions can benefit from the social power of their reputation. Arbitration institutions such as the International Chamber of Commerce (ICC), London Court of International Arbitration (LCIA), and ICSID, for instance, have notable reputations and therefore hold significant power. The reputation of individual arbitrators and arbitration institutions reflects the reputation and power of arbitration system in general. However it is worth noting that although reputation is a valuable and important social power, the focus of this study is mainly on the legal power of arbitrators.

Powers of arbitrators can also be classified based on the degree of the compulsion of these powers. Some of these powers are mandatory and *must* be exercised by arbitrators; some are voluntary and at the *discretion* of arbitrators, which they can exert depending on the circumstances of the case and by considering the principle of 'good faith'.

In cases where powers of arbitrators are mandatory in the sense that it is their duty to comply with some judicial rules, the powers and duties of arbitrators overlap one with another. By way of illustration, one of the powers conferred on arbitrators is the authority to make decisions and issue awards; this is in effect one of the duties of arbitrators as well. Arbitrators are obliged to exercise their power in regard to issuing awards; any failure in exercising this power is in fact equivalent to non-performance of their duty and is considered as misconduct.

To state this another way, based on Hohfeld's theory of jural relation[53] in the relationship between the conflicting parties and arbitrator, the conflicting parties have the right to get their conflicts resolved by referring to arbitration. The correlative of this right of the conflicting parties – or in the language of power, the legal power of the conflicting parties

[53] Hohfeld's theory of jural relation is discussed in Chapter 1 on Power.

against arbitrators – is the liability[54] of arbitrators to resolve conflicts referred to them. Therefore arbitrators have the liability to resolve the parties' conflicts and are empowered with relevant judicial authorities to perform their liabilities.[55]

The other category of arbitrators' powers is voluntary, which means it is at their discretion to exercise those powers. Power in the latter sense is regarded as capacity "which may or may not be exercised" (Lukes, 2005, p. 109). For instance, ordering an interim measure is a power that is delegated to arbitrators, however they have the power to decide whether to exercise it or not. Nonetheless, good faith is an essential principle that should be considered by arbitrators while making decisions in regard to the discretionary powers.

The power that arbitrators possess is delegated to them in order to make decisions. The sources that delegate powers to arbitrators identify the specific powers that arbitrators have. Thus, from a power perspective the study of sources of arbitration involves the study of the delegation and the particular powers that flow from those sources. This thesis seeks to analyse the power of arbitrators in the sense of examining whether and to what extent arbitrators use their judicial authority to balance the interests of the states and investors. The preliminary issue in this respect concerns the identification of the judicial powers of arbitrators that confers on them the ability to balance the power and interests of the conflicting parties. In order to determine the powers that arbitrators have in resolving disputes one has to consider three distinct sources: firstly the arbitration *agreement*, secondly the *law* governing the arbitration agreement, and finally the law governing the arbitration – the *lex arbitri* (Redfern, et al. 2009). In other words, the conflicting parties may delegate specific powers to arbitrators and some powers of arbitrators are determined by the law. In addition to the powers conferred by the parties and the law, arbitrators, like other adjudicators, possess inherent powers that flow from the very judicial nature of their functions. Each of these sources and the powers that originate from them will be examined in the following three sections.

[54] The term 'liability' is used in the sense of the jural correlatives of the concept of rights, which are conceptualised by Hohfeld.

[55] The correlative of the powers of arbitrators against the parties is that the parties must comply with the decisions of the tribunal. In this respect the ICSID Convention, Article 53(1), provides that "The award shall be binding on the parties and shall not be subject to any appeal or to any other remedy except those provided for in this Convention. Each party shall abide by and comply with the terms of the award except to the extent that enforcement shall have been stayed pursuant to the relevant provisions of this Convention." Furthermore the ICC Arbitration Rules, Article 22.5, expressly state: "The parties undertake to comply with any order made by the arbitral tribunal."

I. Powers Conferred by the Parties

The parties have the freedom to refer their disputes to arbitration and to design the framework of the process. "Indeed, the arbitral tribunal owes its very existence to the parties; it is 'their' arbitral tribunal"(Redfern, et al. 2009, 315). Thus the core of arbitration is based on the principle of party autonomy. Party autonomy is the freedom of the parties to decide about the procedural aspects of their dispute settlement and confers ample mutual powers on both of the conflicting parties. These powers are mainly those legal rights that are specified in the law as the rights of the disputing parties or the right to determine an issue of the arbitration agreement based on their freedom of choice and party autonomy.

The law recognises mutual powers for both of the parties, equally, disregarding their position in order to enhance the equality of arms in the process of dispute resolution. For instance in constructing the arbitration, some aspects such as the language of arbitration,[56] the place of arbitration,[57] the law governing the substance of the dispute and the law governing the procedure of arbitration can be decided by the parties. Thus the parties can determine myriad aspects of arbitration. In this respect Article 1 of UNCITRAL provides that even when the Rules of UNCITRAL are applicable these rules may be subject to the modifications of the parties.[58] In other terms, some limited issues, mainly those related to public policy and the coercive power of national courts, are not within the scope of the parties' power to confer on arbitrators (Redfern, et al. 2009). Arbitration rules have supplemental and controlling roles in arbitration; they regularise the mandatory issues related to public policy and non-mandatory issues when the parties fail to agree.

The most important mutual power of the parties in regard to the issue of power is their right to appoint arbitrators. The power of arbitrators initiates from the point of their appointment by the parties. It is at this stage that the parties confer power on particular arbitrators to decide their dispute.

Accordingly, a decisive legal power of the parties pertinent to the arbitration phase is their right to appoint arbitrators. The parties have the right to appoint their own arbitrators

[56] For instance, UNCITRAL Arbitration Rules (2010) Article 19
[57] For instance, UNCITRAL Arbitration Rules (2010) Article 18
[58] Article 1.1 of UNCITRAL: "Where parties have agreed that disputes between them in respect of a defined legal relationship, whether contractual or not, shall be referred to arbitration under the UNCITRAL Arbitration Rules, then such disputes shall be settled in accordance with these Rules subject to such modification as the parties may agree."

and this right is recognised as a basic right in all the arbitration rules.[59] The right to appoint arbitrators gives the parties a legal power to affect the result of the dispute. As the famous maxim '*an arbitration is only as good as the arbitrator'* indicates, the role of arbitrators is crucial in the process and the result of arbitration and the parties by having the power to appoint their arbitrators in fact have impact on the result of the dispute. In the appointment of their arbitrators, parties are concerned about the arbitrators' orientations of thought that can be perceived from their previous awards, opinions and publications (Reinisch, 2009, p. 909).

As a result of the importance of the appointment of arbitrators on the process of dispute resolution, different rules and conventions provide various provisions in regard to the appointment of arbitrators. For instance according to Article 37(2)(a) of the ICSID Convention:

> "(a) The Tribunal shall consist of a sole arbitrator or any uneven number of arbitrators appointed as the parties shall agree.
> (b) Where the parties do not agree upon the number of arbitrators and the method of their appointment, the Tribunal shall consist of three arbitrators, one arbitrator appointed by each party and the third, who shall be the president of the Tribunal, appointed by agreement of the parties."

The UNCITRAL Arbitration Rules on the appointment of arbitrators is to some extent different from the ICSID Convention. Article 9 (1) of the former stipulates that:

> "If three arbitrators are to be appointed, each party shall appoint one arbitrator. The two arbitrators thus appointed shall choose the third arbitrator who will act as the presiding arbitrator of the arbitral tribunal."

According to UNCITRAL Rules the two appointed arbitrators appoint the presiding arbitrator, whereas in ICSID Rules it is a right of the parties to agree on the third arbitrator, and if they fail to agree, the appointing authority designates the presiding arbitrator. The aforementioned example elucidates the fact that in general the parties have the right to appoint their own arbitrators but that the procedures of different rules may vary in relation to the process of appointment of the third arbitrator.

[59] To name but a few of the Arbitration Rules that stipulate the right to appoint arbitrators:
UNCITRAL Arbitration Rules as revised in 2010 Articles 8-10, ICC Arbitration Rules 2012 Articles 12-13, ICSID Arbitration Rules 2006 Articles 1-5, IUSCT Claims Settlement Declaration 1981 Articles III

The traces of power can be found in different aspects of the right to appoint arbitrators: agreement in appointing the sole or the third arbitrator (where applicable depending on the rules governing the arbitration), and agreement in designating the appointing authority. In both cases the bargaining power of the parties determines the scope of the power of each party in influencing the other to agree on his desired arbitrator or the appointing authority. However it is worth mentioning that in some rules the appointing authority is predetermined and the parties have no choice in designating the appointing authority. Even in these cases there is the risk that the more powerful party can influence the appointing authority to appoint arbitrator(s) whose views are more favourable to them. For instance, as Dr Mohebi the former arbitrator at Iran-US Claims Tribunals (IUSCT) asserts the Iranian and American arbitrators could never agree on the third arbitrators, thus the appointing authority – the Secretary General of the Permanent Court of Arbitration (PCA) – had to appoint arbitrators. Regarding his record as an arbitrator, he believes that

> "You could see the shadow of Americans' influence in the procedure of appointment of arbitrators by the appointing authorities. This shadow was most materialised in the approach of the appointing authority in appointment of arbitrators who were pro investor and pro western countries."[60]

Hence appointment of arbitrators can be claimed to be one of the preliminary steps in the exertion of power by the parties in the post-conflict phase. Furthermore, appointment of arbitrators is the initial point where the parties confer power on arbitrators to decide their conflicts. Thus the power of arbitrators emanates from their appointment by the parties.

In the subsequent stages after the appointment process, the conflicting parties may directly confer power to arbitrators. "Such powers are likely to include the power to order production of documents, to appoint experts, to hold hearings, to require the presence of witnesses, to receive evidence, and to inspect the subject-matter of the dispute."(Redfern, et al. 2009, 315) All these powers can be used in a manner to balance the interests of the parties; however an important power that the parties may confer on arbitrators, and which is highly decisive in redressing power imbalances, is the power to decide *ex aequo et bono. Ex aequo et bono* is the power to decide the dispute on the basis of extra legal considerations which are

[60] Dr Mohsen Mohebi, former arbitrator at the IUSCT and the present Secretary General of Arbitration Center of Iran Chamber (ACIC)

equitable; "It is not the nature of the issue but the parties' agreement that makes equity applicable to them." (Schreuer, 2001, p. 634)

The power to decide *ex aequo et bono* is envisaged in various rules and conventions. The International Court of Justice (ICJ) Statute in Article 38(2) establishes the power of the Court to decide *ex aequo et bono* if the parties agree on that.[61] International Chamber of Commerce (ICC) Arbitration Rules Article 21 (3) provides that "The arbitral tribunal shall assume the powers of an *amiable compositeur* or decide *ex aequo et bono* only if the parties have agreed to give it such powers." UNCITRAL Arbitration Rules provide the same rules as ICC in Article 35 (2): "The arbitral tribunal shall decide as *amiable compositeur* or *ex aequo et bono* only if the parties have expressly authorized the arbitral tribunal to do so." In line with the ICJ, ICC and UNCITRAL, ICSID Rules in Article 42 (3) stipulates that "The provisions of paragraphs (1) and (2) shall not prejudice the power of the Tribunal to decide a dispute *ex aequo et bono* if the parties so agree." Furthermore, ICSID Model Clause in Section V recognises the power to decide *ex aequo et bono:*

> *"*Article 42(3) of the Convention provides that a Tribunal may decide a dispute *ex aequo et bono* if the parties so agree. If the parties wish to give the Tribunal the authority so to decide, they may use a clause such as follows. **Clause 11** Any Arbitral Tribunal constituted pursuant to this agreement shall have the power to decide a dispute *ex aequo et bono*."

The salient point in all of the aforementioned rules is that *ex aequo et bono* power must be conferred to arbitrators by the parties. In other words, arbitrators do not have the right to decide *ex aequo et bono* unless they are authorised by the parties; thus the source of this power is the parties. The use of *ex aequo et bono* by arbitrators, without the authorisation of the parties, is an excess of power and can lead to the annulment of the award.

Ex aequo et bono is a power that may be used in balancing power and interests; particularly when a renegotiation is not possible by the parties, the power of arbitrators to decide *ex aequo et bono* brings justice and fairness to the dispute (Schreuer, 2001).

[61] ICJ Statute Article 38(2): "This provision shall not prejudice the power of the Court to decide a case *ex aequo et bono*, if the parties agree thereto."

II. Powers Conferred by the Law

The law governing the arbitration agreement and the law governing the arbitration proceedings regulate the power of arbitrators(Redfern, et al. 2009). Powers that the law confers on arbitrators in fact supplement and/or control the powers that the parties confer on them. In cases where the powers conferred on the parties are limited, the law has a supplemental role. For instance when the parties fail to agree on the applicable law, arbitrators have the power to choose the applicable law.[62] In cases where the powers conferred on the parties are against the public policy, the law controls these powers.

This section will identify the main powers that the law may confer on arbitrators. Some rules and conventions are selected for this purpose. The sampling is based on the preference and frequency of use of the rules or the relevant institution in international arbitration; according to these criteria, Arbitration Rules of the ICC shall be examined.[63] Furthermore, the Rules pertinent to investment arbitration, as the core of this research, merit investigation. Thus in this respect, ICSID, as the only convention specialised in investment, and rules of the IUSCT, as the largest arbitral tribunal, are selected for the purpose of the study of arbitrators' power. As the IUSCT has adopted the UNCITRAL Rules, thus these rules will be scrutinised in order to extract the powers of arbitrators.

i. Competence de la competence

Section 3 of the ICSID Convention is on the *powers and functions of the tribunal* in general. According to Article 41 of the ICSID Convention, arbitrators have the power to judge on their own jurisdiction and decide whether they have the power to arbitrate the case referred to them.[64] The same rule is recognised in UNCITRAL Article 23.1[65] and ICC Rules Article 6.[66]

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[62] For instance, UNCITRAL Article 35.1 provides that: "Failing such designation by the parties, the arbitral tribunal shall apply the law which it determines to be appropriate."

[63] 2010 International Arbitration Survey: Choices in International Arbitration, conducted by Queen Mary University and White & Case, p 23
Preferred arbitration institutions: ICC 50%, LCIA 14%, AAA/ICDR 8%, SIAC 5%, JCAA 4%, HKIAC 4%, Other 14%.
Arbitration institutions used most frequently over the past five years: ICC 56%, AAA/ICDR 10%, LCIA 10%, DIS 6%, SCC 3%, ICSID 3%, SIAC 2%, Other 9%.
Based on this survey the most preferred and the most frequently used institution is ICC, and will therefore be used in this research.

[64] Article 41 of ICSID:
"(1) The Tribunal shall be the judge of its own competence.

ii. Determining the applicable law

Article 42 of the ICSID Convention expressly confers on arbitrators the power to apply the appropriate law in the absence of agreement of the parties. Furthermore, UNCITRAL Rules in Article 35.1 provides arbitrators the power to determine the applicable law in cases where the parties fail to agree. Eventually ICC Article 21 provides that "The parties shall be free to agree upon the rules of law to be applied by the arbitral tribunal to the merits of the dispute. In the absence of any such agreement, the arbitral tribunal shall apply the rules of law which it determines to be appropriate." Furthermore Article 19 states that "The proceedings before the arbitral tribunal shall be governed by the Rules and, where the Rules are silent, by any rules which the parties or, failing them, the arbitral tribunal may settle on, whether or not reference is thereby made to the rules of procedure of a national law to be applied to the arbitration." Therefore the stated rules confer on arbitrators the power to select the applicable law.

iii. Determining the place of arbitration

Similar to the rules of applicable law the place of arbitration may be determined by arbitrators. In other words the law confers on the arbitrators the power to choose the place of arbitration in the absence of agreement of the parties.[67]

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(2) Any objection by a party to the dispute that that dispute is not within the jurisdiction of the Centre, or for other reasons is not within the competence of the Tribunal, shall be considered by the Tribunal which shall determine whether to deal with it as a preliminary question or to join it to the merits of the dispute."

[65] Article 23.1: "The arbitral tribunal shall have the power to rule on its own jurisdiction, including any objections with respect to the existence or validity of the arbitration agreement. For that purpose, an arbitration clause that forms part of a contract shall be treated as an agreement independent of the other terms of the contract. A decision by the arbitral tribunal that the contract is null shall not entail automatically the invalidity of the arbitration clause."
Article 23.3: "The arbitral tribunal may rule on a plea referred to in paragraph 2 either as a preliminary question or in an award on the merits. The arbitral tribunal may continue the arbitral proceedings and make an award, notwithstanding any pending challenge to its jurisdiction before a court."

[66] Article 6.3 of ICC Rules: "…any question of jurisdiction or of whether the claims may be determined together in that arbitration shall be decided directly by the arbitral tribunal…"

[67] ICC Article 18.1: "The place of the arbitration shall be fixed by the Court, unless agreed upon by the parties."
Article 63 of ICSID: Conciliation and arbitration proceedings may be held, if the parties so agree, …
(b) at any other place approved by the Commission or Tribunal after consultation with the Secretary-General.
Article 18.1 of UNCITRAL: "If the parties have not previously agreed on the place of arbitration, the place of arbitration shall be determined by the arbitral tribunal having regard to the circumstances of the case. The award shall be deemed to have been made at the place of arbitration."

iv. Determining the language

Regulation 34 of the Administrative and Financial Regulations of ICSID predetermines the official languages of the Centre.[68] Further, Article 22 of the Arbitration Rules of the ICSID Convention gives the parties the option to agree on languages other than the official languages of the Centre. Thus the ICSID Convention does not confer any power on the arbitrators to determine the language of the proceedings.

UNCITRAL Rules in Article 19.1 provide that "Subject to an agreement by the parties, the arbitral tribunal shall, promptly after its appointment, determine the language or languages to be used in the proceedings."

Article 20 of ICC states that "In the absence of an agreement by the parties, the arbitral tribunal shall determine the language or languages of the arbitration, due regard being given to all relevant circumstances, including the language of the contract."

v. Interim measures

As discussed in the inherent powers of arbitrators below, though Article 47 of ICSID uses the term 'recommend' in relation to granting interim measures, the arbitrators have the power to order these measures in appropriate circumstances.

Article 26 of UNCITRAL expressly acknowledges the power of arbitrators to order interim measures. However the difference between the terms of this rule and ICSID lies in the fact that under the UNCITRAL rules, arbitrators have the power to order interim measures upon the request of the parties, whereas ICSID rules, in this sense confer a wider power to grant interim measures at their own discretion, regarding the circumstances of the case.

ICC Rules in Article 28.2 recognises the power of the arbitrators to order provisional measures: "Before the file is transmitted to the arbitral tribunal, and in appropriate circumstances even thereafter, the parties may apply to any competent judicial authority for interim or conservatory measures. The application of a party to a judicial authority for such measures or for the implementation of any such measures ordered by an arbitral tribunal shall not be deemed to be an infringement or a waiver of the arbitration agreement and shall not affect the relevant powers reserved to the arbitral tribunal."

[68] Regulation 34 (1): "The official languages of the Centre shall be English, French and Spanish.
(2) The texts of these Regulations in each official language shall be equally authentic."

vi. Measures in regard to evidence

Article 43 of ICSID confers on arbitrators the power to gather relevant evidence such as the power to present required documents and examination of the subject matter.[69]

UNCITRAL Rules extensively discuss the evidentiary powers of arbitrators particularly in requiring further statements from the parties[70] and expert determination.[71]

Article 25 of ICC Rules considers the power of arbitrators in regard to collection of evidence.[72] The Rules give the arbitrators the power to summon the parties to provide evidence and in appropriate cases they have the power to request an expert's view on the case.

Overall Document production, requiring presence of witnesses, administration of oaths, appointment of experts, and examination of the subject matter are the main powers of arbitrators in gathering evidence.

vii. Establishment of the procedure

ICC and UNCITRAL Rules have provisions on the effective and efficient process of dispute resolution. In this respect Article 22.2 of ICC states: "In order to ensure effective case management, the arbitral tribunal, after consulting the parties, may adopt such procedural

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[69] Article 43 of ICSID: "Except as the parties otherwise agree, the Tribunal may, if it deems it necessary at any stage of the proceedings,
(a) call upon the parties to produce documents or other evidence, and
(b) visit the scene connected with the dispute, and conduct such inquiries there as it may deem appropriate."

[70] Article 24 of UNCITRAL: "The arbitral tribunal shall decide which further written statements, in addition to the statement of claim and the statement of defence, shall be required from the parties or may be presented by them and shall fix the periods of time for communicating such statements."

[71] Article 29.1 of UNCITRAL: "After consultation with the parties, the arbitral tribunal may appoint one or more independent experts to report to it, in writing, on specific issues to be determined by the arbitral tribunal. A copy of the expert's terms of reference, established by the arbitral tribunal, shall be communicated to the parties."

[72] ICC Arbitration Rules Article 25:
"1 The arbitral tribunal shall proceed within as short a time as possible to establish the facts of the case by all appropriate means.
2 After studying the written submissions of the parties and all documents relied upon, the arbitral tribunal shall hear the parties together in person if any of them so requests or, failing such a request, it may of its own motion decide to hear them.
3 The arbitral tribunal may decide to hear witnesses, experts appointed by the parties or any other person, in the presence of the parties, or in their absence provided they have been duly summoned.
30 ICC Arbitration and ADR Rules
4 The arbitral tribunal, after having consulted the parties, may appoint one or more experts, define their terms of reference and receive their reports. At the request of a party, the parties shall be given the opportunity to question at a hearing any such expert.
5 At any time during the proceedings, the arbitral tribunal may summon any party to provide additional evidence.
6 The arbitral tribunal may decide the case solely on the documents submitted by the parties unless any of the parties requests a hearing."

measures as it considers appropriate, provided that they are not contrary to any agreement of the parties." Additionally, Article 17.1 of UNCITRAL provides that

> "Subject to these Rules, the arbitral tribunal may conduct the arbitration in such manner as it considers appropriate, provided that the parties are treated with equality and that at an appropriate stage of the proceedings each party is given a reasonable opportunity of presenting its case. The arbitral tribunal, in exercising its discretion, shall conduct the proceedings so as to avoid unnecessary delay and expense and to provide a fair and efficient process for resolving the parties' dispute."

These provisions delegate to arbitrators a general and ample power to proceed the dispute fairly and efficiently. More specifically, the ICSID Convention in Article 45 (2) provides the power to manage the procedure of the dispute resolution:

> "If a party fails to appear or to present his case at any stage of the proceedings the other party may request the Tribunal to deal with the questions submitted to it and to render an award. Before rendering an award, the Tribunal shall notify, and grant a period of grace to, the party failing to appear or to present its case, unless it is satisfied that that party does not intend to do so."

Along the same lines, ICC Rules in Article 26.2 stipulates that "If any of the parties, although duly summoned, fails to appear without valid excuse, the arbitral tribunal shall have the power to proceed with the hearing."

Further powers of arbitrators provided by the law may be named as confidentiality,[73] stay of the proceedings,[74] correction,[75] interpretation,[76] annulment of the award,[77]

[73] ICC Article 22.3: "Upon the request of any party, the arbitral tribunal may make orders concerning the confidentiality of the arbitration proceedings or of any other matters in connection with the arbitration and may take measures for protecting trade secrets and confidential information."
[74] Article 17.3 UNCITRAL: "3. If at an appropriate stage of the proceedings any party so requests, the arbitral tribunal shall hold hearings for the presentation of evidence by witnesses, including expert witnesses, or for oral argument. In the absence of such a request, the arbitral tribunal shall decide whether to hold such hearings or whether the proceedings shall be conducted on the basis of documents and other materials."
[75] UNCITRAL Article 38. 2: "The arbitral tribunal may within 30 days after the communication of the award make such corrections on its own initiative."
ICSID Article 25: "An accidental error in any instrument or supporting document may, with the consent of the other party or by leave of the Tribunal, be corrected at any time before the award is rendered."
[76] UNCITRAL Article 37.1: "Within 30 days after the receipt of the award, a party, with notice to the other parties, may request that the arbitral tribunal give an interpretation of the award."
ICSID Article 51 of the Arbitration Rules

counterclaims,[78] interference of a third party,[79] termination of the proceedings,[80] and appointment of the third arbitrator.[81]

III. Inherent Powers

The proliferation of investment treaties, investment conflicts, and consequently the rise in resort to arbitration for resolution of these disputes, highlight the role of investment arbitration as a crucial international organ in administration of international justice along with other international courts and tribunals. This task is chiefly undertaken by the inherent powers of the tribunals. Before exploring inherent powers in investment arbitration, a controversial argument on the applicability of inherent powers in relation to arbitration deserves to be mentioned.

One may claim, "A body that is created by a legal instrument does not have "inherent" powers. It has only powers that are conferred to it by that instrument, either expressly or by necessary implication" ((*Camera Care Ltd v Commission,* 1980, 135) in (Brown 2005, 210)). Although this claim is in relation to international courts, it can be expanded to arbitration, so

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Based on Article VI (4) of the Claims Settlement Declaration and General Declaration, the IUSCT has the power to interpret the Algeria Agreement.

[77] Article 52 of Arbitration Rules

[78] UNCITRAL Article 22: "During the course of the arbitral proceedings, a party may amend or supplement its claim or defence, including a counterclaim or a claim for the purpose of a set-off, unless the arbitral tribunal considers it inappropriate to allow such amendment or supplement having regard to the delay in making it or prejudice to other parties or any other circumstances…"
ICSID Article 46: "Except as the parties otherwise agree, the Tribunal shall, if requested by a party, determine any incidental or additional claims or counterclaims arising directly out of the subject-matter of the dispute provided that they are within the scope of the consent of the parties and are otherwise within the jurisdiction of the Centre."

[79] UNCITRAL Article 17.5
The Tribunal's power to adjudicate claims derives from the Claims Settlement Declaration, not from the consent of individual parties to cases.

[80] UNCITRAL Article 36.2: "…the arbitral tribunal shall inform the parties of its intention to issue an order for the termination of the proceedings. The arbitral tribunal shall have the power to issue such an order unless there are remaining matters that may need to be decided and the arbitral tribunal considers it appropriate to do so."

[81] Article 9 of UNCITRAL: "1. If three arbitrators are to be appointed, each party shall appoint one arbitrator. The two arbitrators thus appointed shall choose the third arbitrator who will act as the presiding arbitrator of the arbitral tribunal. If within 30 days after the receipt of a party's notification of the appointment of an arbitrator the other party has not notified the first party of the arbitrator it has appointed, the first party may request the appointing authority to appoint the second arbitrator."
One of the circumstances under which the power of arbitrators is greatly observable is the appointment of arbitrators in multiparty arbitrations. As Article 10.3 of UNCITRAL provides, "In the event of any failure to constitute the arbitral tribunal under these Rules, the appointing authority shall, at the request of any party, constitute the arbitral tribunal and, in doing so, may revoke any appointment already made and appoint or reappoint each of the arbitrators and designate one of them as the presiding arbitrator."

that a body, which is created by the consent of the disputing parties, has only powers that are conferred on it by the parties or the rules. However, this claim can be rejected. It is true that arbitration is constituted by the consent of the parties, and the parties confer power on the arbitrators to resolve their disputes, nonetheless after arbitration is formed, it functions as an independent judicial body and possesses all the powers attributed to its nature in order to administer justice. Therefore the power of arbitrators is not confined to the powers conferred by the parties and the law; arbitrators can exercise inherent powers to perform their duties.

Now the focus will turn to the analysis of inherent powers in investment arbitration. For this purpose the nature of inherent power including its historical roots will be examined. Then the sources that justify the existence of such powers will be explored. Eventually different types of inherent powers acknowledged by different rules and tribunals, as a non-exhaustive typology, will be identified in order to shed light on the application of the concept of inherent powers in jurisprudence.

i. The Nature of Inherent Powers

The nature of inherent power has its roots in the common legal system, particularly the English Law system. In the 1880s the English courts started to use the term 'inherent' in respect to various powers of the court such as power to correct errors (*Lawrie v. Lees,* 1881, p. 35), power to stay vexatious proceedings, to prevent the abuse of the process and to protect the court proceedings (*McHenry v Lewis,* 1882, p. 202) (*Metropolitan Bank v Pooley,* 1885, p. 220).

The concept of inherent powers of the courts at common law is used interchangeably with 'inherent jurisdiction.' Accordingly, the first meaning of inherent power is correlated with the meaning of jurisdiction,[82] and it explains the powers of the superior courts over the inferior courts. In this sense inherent powers are prerogatives of higher courts. However, the record of English cases exposes the fact that 'all' courts, disregarding their degree, possess and can exercise inherent powers. In *Metropolitan v Pooley*, as one of the oldest cases dealing with inherent powers, it was held that:

[82] ""Jurisdiction" means power or source of powers." Martin S. Dockray, "The Inherent Jurisdiction to Regulate Civil Proceedings," *Law Quarterly Review* 113 (1997)

> "The power seemed to be inherent in the jurisdiction of every Court of Justice to protect itself from the abuse of its own procedure." (*The Metropolitan Bank Limited and Arthur Cooper v Alexander Gopsell Pooley*, 1884-85, p. 215)

In a more recent case at the House of Lords, Lord Morris of Borth-Y-Gest stipulates:

> "There can be no doubt that a court which is endowed with a particular jurisdiction has powers which are necessary to enable it to act effectively within such jurisdiction. I would regard them as powers which are inherent in its jurisdiction. A court must enjoy such powers in order to enforce its rules of practice and to suppress any abuses of its process and to defeat any attempted thwarting of its process." (*Connelly v Director of Public Prosecutions***,** 1964, p 1302)

Further meanings of inherent powers in the common legal system can be explained in light of the nature and the functions of the courts. The nature of adjudication – which is to resolve disputes and administer justice – and the judicial functions that adjudicators operate, necessitate inherent powers (Dockray 1997).

Considering the history of inherent powers in English Law, particularly the two latter meanings, it can be discerned that the theoretical justification behind the concept of inherent powers at common law is based on the need to manage the process of adjudication effectively (Dockray 1997). The exercise of inherent powers is at the discretion of the courts and in line with their principal objective, which is administration of justice. Thus the scope of inherent powers cannot be exclusively confined to English courts and all the adjudication bodies possess inherent powers to protect and administer justice effectively.

At the international level, the inherent powers of the courts are recognised by different bodies. Judge Higgins in her Separate Opinion in Legality of Use of Force (*Serbia & Montenegro v Belgium,* 2004) asserts that inherent powers are necessary "to protect the integrity of the judicial process" (para. 12). She further explains inherent powers of the International Court of Justice (ICJ) and international courts in general as follows:

> "The Court's inherent jurisdiction derives from its judicial character and the need for powers to regulate matters connected with the administration of justice, not every aspect of which may have been foreseen in the Rules. It was on such a basis that the Permanent Court had admitted the filing of preliminary objections to jurisdiction even

before this possibility was regulated by the Rules of Court." (Judge Higgins, ICJ, Legality of Use of Force (*Serbia & Montenegro v Belgium*) Separate Opinion, 2004, p. 338,9)

The ICSID Convention also approves the necessity of inherent powers for the efficacy of arbitration process. In Article 44, the Convention impliedly underlines inherent powers by conferring on the arbitrators the power to "decide the question" even when that question is not covered by any rules.[83]

As for the World Trade Organisation (WTO), it can be claimed, "to the extent that a principle *is* applicable under inherent jurisdiction, that principle *may* apply in WTO dispute settlement as long as its application is consistent with the Covered Agreements" (Mitchell and Heaton 2010, 568). In other words the WTO is not exempted from other international tribunals; its nature as an adjudicatory body justifies the application of inherent powers.

Article 17 of UNCITRAL Arbitration Rules 2010 impliedly highlights the need for inherent powers for arbitrators to function in an effective manner.[84] Furthermore the Iran-US Claims Tribunal, which shall "conduct its business in accordance with the arbitration rules of the United Nations Commission on International Trade Law (UNCITRAL)"[85] in Article 15 of the Tribunal Rules of Procedure follows the approach of the UNCITRAL Rules (1976) in relation to inherent powers of arbitrators. Iran-US Claims Tribunal is a great source for exploring the use of inherent powers by arbitrators. Despite extensive reference to inherent powers in regard to different issues, the Iran-US Claims Tribunal, like other tribunals, has not provided any definition of these powers. This is clearly demonstrated in *Federica Lincoln Riahi v The Government of the Islamic Republic of Iran*:

"So far, neither the Full Tribunal nor any of the Chambers of the Tribunal have been

[83] Article 44 of ICSID Convention: "Any arbitration proceeding shall be conducted in accordance with the provisions of this Section and, except as the parties otherwise agree, in accordance with the Arbitration Rules in effect on the date on which the parties consented to arbitration. If any question of procedure arises which is not covered by this Section or the Arbitration Rules or any rules agreed by the parties, the Tribunal shall decide the question."

[84] Article 17 of UNCITRAL as revised in 2010: "Subject to these Rules, the arbitral tribunal may conduct the arbitration in such manner as it considers appropriate, provided that the parties are treated with equality and that at an appropriate stage of the proceedings each party is given a reasonable opportunity of presenting its case. The arbitral tribunal, in exercising its discretion, shall conduct the proceedings so as to avoid unnecessary delay and expense and to provide a fair and efficient process for resolving the parties' dispute."

[85] Declaration of the Government of the Democratic and Popular Republic of Algeria Concerning the Settlement of Claims by the Government of the United States of America and the Government of Islamic Republic of Iran (Claims Settlement Declaration) 1981, Article III (2)

> prepared or even willing to formulate any definition of what is meant by the term "inherent power". This is due to the generally accepted interpretation that is based on the Algiers Declarations (Article IV, paragraphs 1 and 3, in particular, which gives a final and binding nature to the Tribunal's awards and decisions) and on the clear terms adopted by the Tribunal Rules in Article 32 (2)." (*Federica Lincoln Riahi v The Government of the Islamic Republic of Iran,* 2004, para. 38)

In a subsequent case, the Tribunal approaches the issue of inherent powers in the following terms:

> "The Tribunal now turns to the question of inherent powers of international courts and tribunals. As a general matter, the Tribunal accepts that an international arbitral tribunal, such as the present one, possesses certain inherent powers. Inherent powers "are those powers that are not explicitly granted to the tribunal but must be seen as a necessary consequence of the parties' fundamental intent to create an institution with a judicial nature." It has been suggested that "the source of the inherent powers of international courts is their need to ensure the fulfillment of their functions." Thus, for example, the Tribunal has held that it has "an inherent power to issue such orders as may be necessary to conserve the respective rights of the Parties and to ensure that this Tribunal's jurisdiction and authority are made fully effective.'"(*The Islamic Republic of Iran v The United States of America* , 2011, para. 59)

In fact, once more the Tribunal is reluctant to define inherent powers, and instead it refers to scholarly definitions. Notwithstanding, and as will be examined in the following subsections, the IUSCT has widely and in different circumstances applied inherent powers.[86]

Along with the aforementioned courts and tribunals, other adjudication bodies have acknowledged the existence of inherent powers expressly, or impliedly in practice, however, no definition is provided for this concept. Instead the notion of inherent powers is developed in light of the sources as well as the types of these powers.

[86] For instance in *INA Corporation v. The Government of the Islamic Republic of Iran*, IUSCT, Case No 161, 1985

ii. Sources of Inherent powers

There are different schools of thought on the sources of inherent powers. Some equate inherent power with *implied powers*, which are unexpressed powers by the legislator, parties, and/or the establishers of the tribunal. The notion of inherent powers is close to that of implied powers, and they may even be used interchangeably. However, an in-depth examination of the two concepts reveals their distinctions. Inherent powers are concerned with the *essence* and nature of powers, whereas implied powers are about the *appearance* and the manifestation of powers (Paparinskis 2012). The latter is an antonym of express powers, which are those powers that are expressly stipulated in the law, contract, treaty or other legal instruments. Inherent powers may be express or implied; in other words the powers that concern the nature of judicial bodies may be specified expressly or they may not be exposed (Paparinskis 2012). An ICSID tribunal illustrates this issue in regard to stay of the proceedings:

> "A Tribunal has inherent power to take measures to preserve the integrity of the proceedings. In part that inherent power finds as a textual foot-hold Article 44 of the Convention, which authorises the Tribunal to decide "any question of procedure, not expressly dealt with in the Convention, the ICSID arbitration rules, or any rule agreed by the parties." ICSID Rule 41 does not specifically provide for a situation where there are new challenges to jurisdiction after the issuing of an award on jurisdiction. More broadly, there is an inherent power of an international tribunal to deal with any issues necessary for the conduct of matters falling within its jurisdiction. That power exists independently of any statutory reference. In the specific circumstances of the present case it was, in the Tribunal's view, both necessary and appropriate to take action under its inherent power to ensure the continuity and fairness of the proceedings." (*Siag and Vecchi v Egypt,* 2009, para. 366)

In cases where inherent powers are implied, they can be inferred by virtue of interpretation, by considering the requirement of good faith under article 31(1) of the Vienna Convention.[87] In the words of Brown:

[87] Article 31.1 of the Vienna Convention on Law of Treaties provides: "A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose."

> "The doctrine of implied powers has been used by international courts far more frequently in the context of the powers of international organizations. In contrast, when they have claimed powers for themselves which are not expressly provided for in their constitutive instruments, international courts have in general not sought to imply powers from the express terms of their statutes" (Brown 2005, 226).

Thus, generally, adjudicatory bodies rather than organisations exercise inherent powers. Considering the distinction between inherent and implied powers, it is possible to reject the fact that the source of inherent powers is implied powers.

A more rational justification for the sources of inherent power is to consider these powers as a general concept that covers all the powers that originate from the *judicial nature* and *function* of the tribunal, which concentrates on the administration of justice(Gaeta 2003). Among different views on the notion of inherent powers the latter is predominant and is compatible with the present subject. Therefore inherent powers are considered as the powers that arbitrators have as a result of the judicial nature of their position and in order to perform their judicial functions. In other words, the functions of the tribunals justify the use of inherent powers. Depending on the type of functions, the type of powers of tribunals varies.

Primarily international tribunals including investment arbitration tribunals have to accomplish private functions to settle disputes between the specific conflicting parties that have referred their conflict before the arbitration tribunal. This function is private as it is confined to the parties that had recourse to arbitration.

Nevertheless, behind the veil of the private functions, international tribunals, including investment arbitration tribunals perform public functions. As is claimed, "This is distinct from the function of settling disputes, in that it emphasizes the need for effectiveness and efficiency in judicial decision-making" (Brown 2005). As the objective of this thesis is to assess the effectiveness of investment arbitration as a judicial body, it is therefore essential to scrutinise the public aspect of arbitrators' functions.

As is expressly stipulated by the Special Tribunal for Lebanon, inherent powers serve the public functions of the international tribunals. It then elucidates the public functions as follows:

> "The practice of international judicial bodies shows that the rule endowing international tribunals with inherent jurisdiction has the general goal of remedying possible gaps in the legal regulation of the proceedings. More specifically, it serves one or more of the following purposes: (i) to ensure the fair administration of justice, (ii) to control the process and the proper conduct of the proceedings; (iii) to safeguard and ensure the discharge by the court of its judicial functions (for instance, by dealing with contempt of the court)." (2010, para. 48).

Furthermore, the public functions of the courts are categorised as: control and management of the process, prevention of abuse of process and protecting the tribunal's process, development of international law, consideration of interests of third parties – parties other than the disputing parties – and lending legitimacy to the international dispute resolution system by detaching the process from power-oriented arrangements (Brown 2005).

Synthesising different public functions of international tribunals, it can be perceived that the public functions of international tribunals can be inductively developed to investment arbitration, as an international adjudicatory body. Accordingly, the public functions of international investment arbitration can be examined in an array of control and management of the process of the proceedings, legitimisation of the settlement of disputes in the international domain, administration of international justice, and development of the international law – more specifically investment law.

Management of the process of dispute settlement is inherent to any resolution mechanism; it is not possible to perform a duty without having the power to manage the performance of that duty. One of the objectives of inherent powers is to confer on arbitrators the capability to manage and control the process of dispute resolution effectively. Management of the process of arbitration underlines an essential power of arbitrators in relation to balancing the power of the parties.[88] In this respect the arbitrator has the duty to provide and ensure that the disputing parties have the opportunity to present their own case. This mechanism of management of dispute resolution safeguards the application of the maxim of 'equality before the law'.[89] Although the disputing parties have legal rights to present their case before the law and benefit from fair proceedings, they cannot abuse their right in a manner that affects the other party or the integrity of the tribunal. For instance one

[88] Dr Mohsen Mohebi, The Secretary General of Arbitration Centre of Iran Chamber (ACIC)
[89] Equality before the law as one of the principles pertinent to the rule of law is discussed in the following parts.

party cannot unjustly delay the proceeding by refusing to present evidence or witnesses. The parties have the right to benefit from and exercise their legal rights; nonetheless they ought to consider good faith in the exercise of their rights. Accordingly, prevention of any abuse and protection of the tribunal's process is a further mechanism for management of the proceedings that arbitrators must consider. Consequently, inherent powers enable arbitrators to perform the public function of management of the arbitration process, which promotes balance of power and effectiveness of arbitration.

Management of the proceedings is a derivative of a more general public function of the tribunals: **administration of international justice**. The emergence of inherent powers is for the need to promote justice, which is the central function of any tribunal in resolution of conflicts, including arbitration (Weiss 2009). Recall that arbitrators gain their powers from different sources such as the parties and the law; in some cases these sources may not be sufficient to promote justice, therefore they can exercise their inherent powers to fill this gap.

A further public function is the **development of international law.** As Sir Lauterpacht expresses, "The development of international law by international tribunals is, in the long run, one of the important conditions of their continued successful functioning and of their jurisdiction" (Lauterpacht 2010, 7). The function of development of international law particularly has applicability in regard to the field of international investment law, which is a relatively new branch of international law. Thus arbitrators have an important role in protecting as well as developing international investment law. The inherent powers of arbitrators are crucial to performing this aspect of public functions in order to enhance the effectiveness of investment of arbitration.

An essential public function of international tribunals is **to legitimise the dispute settlement process and prevent power-oriented settlements**. This function of arbitration is the core argument of this thesis and will be investigated extensively in the following chapter. In a nutshell the use of inherent powers in order to effectively fulfil judicial duties indicates the fact that the process of dispute resolution is based on the legal power of the arbitrators and the rule of law. The rule of law is a prerequisite for legitimacy. On the other hand, rule by law is the superiority of power that masquerades under the guise of the law and leads to illegitimacy of the dispute settlement process. The use of inherent powers by arbitrators plays a crucial role in enhancing the legitimacy of investment arbitration and to ensure that this mechanism functions on the basis of the law and is not oriented by the power of the parties.

Furthermore, this public function of arbitrators has great impact on the effectiveness of investment arbitration as a whole. In other words the exercise of inherent powers can enhance the legitimacy and effectiveness of arbitration.

iii. Types of Inherent Powers

Following the analysis of the nature and sources of inherent powers, it is of importance to identify different types of these powers. It is not possible to provide an exhaustive list of inherent powers; however, some of these powers are determined in various cases by different international tribunals. The following list can be used as a guideline of inherent powers:

> "the power to establish their main jurisdiction (the so-called *competence de la competence),* the power to interpret or review their own judgments, to correct material errors in their judgments, to make judicial findings necessary for the exercise of their primary jurisdiction, to issue interim measures, to issue orders for the cessation or discontinuance of a wrongful act or omission, to evaluate the credibility of a witness, to sanction disorderly conduct in proceedings or to pronounce and act upon contempt of the tribunal, to impose costs in the case of frivolous, vexatious or repeated complaints, to regulate their own procedure, to ascertain *motu proprio* whether the conduct of the State could be held in breach of certain obligations different from those alleged in the original complaint, and so on"(Gaeta 2003, 358).

In order to shed light on the application of the inherent powers in jurisprudence some of the aforementioned inherent powers that are pertinent to the topic will be further elucidated, by referring to procedures of international tribunals. These powers are appropriate tools for arbitrators to administer justice, particularly to balance the power inequalities and conflict of interests between the parties.

Interim measures are one of the means by which the arbitral tribunal may wield its power in order to redress the power imbalance of the disputing parties. Indeed one of the objectives in issuing interim measures is the balance of convenience (Blackaby, et al. 2009, 323). Interim measures are treated differently under the rules of different institutions. Article 23(1) of the ICC Rules of Arbitration 1998 states that:

> "Unless the parties have otherwise agreed, as soon as the file has been transmitted to it, the Arbitral Tribunal may, at the request of a party, order any interim or conservatory measure it deems appropriate. The Arbitral Tribunal may make the granting of any such measure subject to appropriate security being furnished by the requesting party. Any such measure shall take the form of an order, giving reasons, or of an Award, as the Arbitral Tribunal considers appropriate."

According to Article 47 of the ICSID Convention:

> "Except as the parties otherwise agree, the Tribunal may, if it considers that the circumstances so require, recommend any provisional measures which should be taken to preserve the respective rights of either party."

Comparing ICSID and ICC rules in regard to interim measures, it may be claimed that the term 'recommend' indicates the importance of investment disputes – particularly because of the presence of the state as one of the disputing parties – and the limitation of arbitrators' power to order interim measures (Blackaby, et al. 2009, 322).

However, it is worth mentioning that interim measures ordered by the ICSID arbitral tribunals are as binding as those issued by other arbitral tribunals (Schreuer, 2001). In this regard in *Emilio Agustin Maffezini v Kingdom of Spain* (2001) it was held that:

> "The Tribunal's authority to rule on provisional measures is not less binding than that of a final award. Accordingly, for the purposes of this order, the tribunal deems the word "recommend" to be of equivalent value as the word "order."" (para. 9)

Furthermore, in *Occidental Petroleum Corporation and Occidental Exploration and Production Company v Republic of Ecuador* (2007) the tribunal illustrates the notion of the term 'recommend' by stating that:

> "The Tribunal wishes to make clear for the avoidance of doubt that, although Article 47 of the ICSID Convention uses the word "recommend", the Tribunal is, in fact, empowered to order provisional measures." (para. 58)

Further in that case, the tribunal underlines the purpose of interim measures, which is "to guarantee the protection of rights whose existence might be jeopardized in the absence of such measures" (para. 60) and continues:

> "It is also well established that provisional measures should only be granted in situations of necessity and urgency in order to protect rights that could, absent such measures, be definitely lost. It is not contested that provisional measures are extraordinary measures which should not be recommended lightly. In other words, the circumstances under which provisional measures are required under Article 47 of the ICSID Convention are those in which the measures are necessary to preserve a party's rights and where the need is urgent in order to avoid irreparable harm." (para 59)

Despite being expressly specified by the conventions and rules, interim measures are inherent to the nature of adjudication and therefore arbitrators can exert this power to administer justice. To put it another way, interim measures may be express or implied; in either case they are inherent powers that can be applied by the tribunals.

Furthermore the practice of Iran-US Claims Tribunals clearly indicates the inherent nature of interim measures. Numerous cases in IUSCT have referred to inherent powers of arbitrators, but this is even more extensively analysed in relation to interim measures.[90] The

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[90] *Rockwell International Systems, Inc, Claimant, v The Government of The Islamic Republic of Iran, Ministry of Defence*, IUSCT, Case No. 430, 1983
Reading & Bates Corporation, Reading & Bates Exploration Company, Claimants, v The Islamic Republic of Iran, National Iranian Oil Company, Iranian Marine International Oil Co, IUSCT, Case No. 28, 1983
The Government of the United States of America, on Behalf And For The Benefit of Shipside Packing Company, Incorporated, Claimant, v The Islamic Republic of Iran (Ministry of Roads and Transportation), IUSCT, Case No 11875, 1983
The Government of the United States of America, on Behalf And For The Benefit off Tadjer-Cohen Associates, Incorporated, Claimant, v The Islamic Republic of Iran, IUSCT, Case NO 12118, 1985
Component Builders, Inc., Wood Components Co. And Moshofsky Enterprises, Inc., Claimants, v The Islamic Republic Of Iran, Bank Maskan Iran [Successor To Bank Rahni Iran] And Insurance Company of Iran, IUSCT, Case No. 395, 1985.
The Government of the United States of America, On Behalf And For The Benefit of Linen, Fortinberry And Associates, Incorporated, Claimant, v The Islamic Republic of Iran, IUSCT, Case No. 10513, 1985
Aeronutronics Overseas Services, Inc., Claimant, v The Government Of The Islamic Republic of Iran, The Air Force of The Islamic Republic of Iran, Bank Markazi Iran, IUSCT, Case No. 158, 1985.
Ford Aerospace & Communications Corporation And Aeronutronic Overseas Services, Inc., Claimants, v The Air Force of The Islamic Republic of Iran, The Ground Forces of The Islamic Republic of Iran, The Ministry of Defense of The Islamic Republic of Iran, Government of Iran, IUSCT, Case No. 159, 1984.
Rca Globcom Communications Inc. (Rca Globcom Inc.), Rca Global Communicationsdisc, Inc. (Rca Globcom Disc), Rca Globcom Systems, Inc., v The Islamic Republic of Iran, Telecommunication Company Of Iran, The Islamic Republic of Iran's, Army Joint Staff Bank Melli Iran, Bank Markazi, Foreign Trade Bank of Iran, IUSCT, Case No. 160, 1983

tribunal in *E-Systems, Inc, Claimant, v The Government of the Islamic Republic of Iran, Bank Melli Iran* (1983) states:

> "This Tribunal has an inherent power to issue such orders as may be necessary to conserve the respective rights of the Parties and to ensure that this Tribunal's jurisdiction and authority are made fully effective."

Moreover Article 26, paragraph 1, of UNCITRAL Arbitration Rules, empowers the Tribunal to grant interim measures of protection:

> "At the request of either party, the arbitral tribunal may take any interim measures it deems necessary in respect of the subject-matter of the dispute, including measures for the conservation of the goods forming the subject- matter in dispute, such as ordering their deposit with a third person or the sale of perishable goods."[91]

Considering the relevant cases and rules, the point of note is that the objective of interim measures is to preserve the right of the parties. This objective is impliedly correlated with the issue of power. Arbitrators with their inherent power – which may be expressly articulated in the rules such as in UNCITRAL, IUSCT, and ICSID – can grant interim measures in cases where one of the parties is abusing his right. By ordering interim measures, the tribunal prevents any abuse of power and redresses power imbalances. Therefore interim measures are effective powers for arbitrators to administer justice where the powerful party is abusing his right.

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[91] UNCITRAL Rules 1976 are adopted by IUSCT. This article is identical to Article 26 of the UNCITRAL Arbitration Rules Article as revised in 2010.
"1. The arbitral tribunal may, at the request of a party, grant interim measures.
2. An interim measure is any temporary measure by which, at any time prior to the issuance of the award by which the dispute is finally decided, the arbitral tribunal orders a party, for example and without limitation, to:

1. *(a)* Maintain or restore the status quo pending determination of the dispute;
2. *(b)* Take action that would prevent, or refrain from taking action that is likely to cause, (i) current or imminent harm or (ii) prejudice to the arbitral process itself;
3. *(c)* Provide a means of preserving assets out of which a subsequent award may be satisfied; or
4. *(d)* Preserve evidence that may be relevant and material to the resolution of the dispute.

3. The party requesting an interim measure under paragraphs 2 *(a)* to *(c)* shall satisfy the arbitral tribunal that:
(a) Harm not adequately reparable by an award of damages is likely to result if the measure is not ordered, and such harm substantially outweighs the harm that is likely to result to the party against whom the measure is directed if the measure is granted; and
(b) There is a reasonable possibility that the requesting party will succeed on the merits of the claim. The determination on this possibility shall not affect the discretion of the arbitral tribunal in making any subsequent determination."

Interpretation is a decisive inherent power of arbitrators particularly in balancing the inequalities of the parties. Interpretation is a discretionary and subjective issue. Thus the interpreter, here the arbitrator, is at the risk to interpret arbitrarily. In this case interpretation is not a mechanism for balance of power and administration of justice; it is a means to further discrimination. For instance, in *Bridas SAPIC v Turkmenistan* (2003), the arbitrators manifestly misused their power of interpretation and imposed the arbitration clause to the third party by interpreting it widely.[92]

The theoretical and ideological background of arbitrators is a determinant factor that shapes their perception from the desired document. Accordingly, some arbitrators may be pro investor and some others pro state. Arbitrators, regarding their roles as neutral third party dispute resolvers, must be pro investment and interpret disregarding their personal ideology.

Article 31(1) of the Vienna Convention on the Law of Treaties expressly points to the method of interpretation: "A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose" (Vienna Convention on the Law of Treaties, 1969). Thus good faith is an essential factor in interpreting documents and laws. Good faith requires that the terms of the treaty, contract, convention and/or any rule be interpreted "in a fair and reasonable manner, to the intention of the parties" (Lauterpacht 2010, 292). Therefore the maxim of good faith shall be considered as a control for discretionary interpretation.

A widespread misconception in interpreting BITs by considering the wording of Article 31 is best explained by Dolzer:

> "it might be argued that a teleological approach to interpreting bilateral or multilateral treaties should be based on the assumption that these treaties have been negotiated to facilitate and promote foreign investment, which is often reflected in the wording of the preambles. Thus, it might be concluded that, when in doubt, these treaties should be interpreted *infavorem* investor, stressing and expanding his rights so as to promote the flow of foreign investment. Such a line of thinking would, of course, be inconsistent with the classical rule – no longer generally accepted today – that treaties should be interpreted *in favorem* state sovereignty." (Dolzer, 2002, p. 73-74).

[92] Further example: *Loewen Group, Inc. and Raymond L. Loewen v. United States* ICSID Case No ARB(AF)/98/3 (NAFTA)

He continues: “investment treaties are meant to benefit both investor and host state and that they are based on the recognition of the rights and obligations of both the host state and the investor” (Dolzer, 2002, p. 74). This argumentation approves the view that the arbitrators’ approach must be pro investment.

All the arbitral tribunals inherently have the power to decide their own jurisdiction over the referred case, which is called **Competence de la competence**. In UNCITRAL Arbitration Rules, Article 23 expressly identifies the power of arbitrators to decide on their own jurisdiction:

> “The arbitral tribunal shall have the power to rule on its own jurisdiction, including any objections with respect to the existence or validity of the arbitration agreement. For that purpose, an arbitration clause that forms part of a contract shall be treated as an agreement independent of the other terms of the contract. A decision by the arbitral tribunal that the contract is null shall not entail automatically the invalidity of the arbitration clause” (UNCITRAL, 2010, Article 23).

The IUSCT, in Article 21 of the Rules of Procedures, follows the UNCITRAL provisions. Although the power of the tribunal to decide its jurisdiction is expressly stipulated in the text of UNCITRAL and IUSCT Rules of Procedure, this by no means changes the inherent nature of this power. In other words, even if competence de la competence had not been mentioned in the relevant conventions, it would not have affected the ability of the tribunals to exercise this power.

Disorderly conduct and contempt of the tribunal is a further form of the inherent powers of arbitrators. The extreme form of the power of arbitrators in restoring the balance is to *exclude the misbehaving party from the process* (*Bogdanov v. Moldova,* 2009) (Wälde, 2010). To a lesser degree *contempt* is a power of the courts that can be extended to arbitral tribunals; it is the power to restrain any disregard and violation of the tribunals’ order.

Furthermore, the arbitral tribunal has the inherent power to **exclude evidences that are acquired improperly** such as by torture, intimidation. However, evidence that is obtained by illegal ways “may help it to find other evidence in proper ways” (Wälde, 2010, p. 185).

Adverse inference is one of the powerful tools that arbitral tribunals have in cases where the rogue party refuses to provide requested evidence or destroys them. In these situations the tribunal has the power to infer that the requested evidence could have been in benefit for the innocent and against the rogue party. Adverse inference generates a coercive power by which the tribunal can threaten the refusing party to cooperate with the tribunal "without having to take a clear stance on more controversial measures such as exclusion or contempt" (Wälde, 2010, p. 185).

Cost sanctions and punitive damages is the power of the arbitral tribunals for redressing the imbalance caused as a result of the misconduct of one of the parties. In this case the arbitral tribunal has the power to award punitive damages beyond normal damages, for instance for expropriation by the host state.

Inherent power to revise an award,[93] inherent power to reinstate and revise a case,[94] discontinuance and stay of the proceedings[95] are further inherent powers of tribunals that are addressed by different courts and arbitral tribunals.

To sum up, the aforementioned non-exhaustive samples of inherent powers represent the capability of the tribunals to exercise power to balance the power inequalities and administer justice. However, as the scope and notion of inherent powers are wide and uncertain, there is the risk of abuse by arbitrators. In other words, the breadth of inherent

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[93] *The Islamic Republic of Iran v The United States of America, IUSCT,* Case No A33, 2011
Henry Morris, v. Government Of The Islamic Republic Of Iran, Bank Mellat (Formerly Iran-Arab Bank) 1983
World Farmers Trading Incorporated, Claimant, v Government Trading Corporation, Bank Melli Iran, Bank Markazi Iran, 1990
Dames & Moore, Claimant, v The Islamic Republic of Iran, The Atomic Energy Organization Of Iran, The National Iranian Steel Company, The Iranian Medical Center And The National Iranian Gas Company. 1985
[94] *Gloria Jean Cherafat, Roxanne June Cherafat, Ramin Cherafat, Claimants v The Islamic Republic of Iran, 1992,* No. 277
Ram International Industries, Inc., Universal Electronics, Inc., General Aviation Supply, Inc., Galaxy Electronics Corp., Claimants, v The Air Force of The Islamic Republic Of Iran, Case No. 148, 1993
Harold Birnbaum, Claimant, v the Islamic Republic of Iran, Case No. 967, 1995
Frederica Lincoln Riahi, Claimant v The Government of The Islamic Republic of Iran, Respondent, Case No. 485, 2004
The United States Of America, Claimant v The Islamic Republic Of Iran, Case No: B36, 1997
[95] *InterAgua Servicios Integrales del Agua S.A. v Argentina,* ICSID Case no ARB/03/17, Decision on Liability, July 30, 2010 [18]: "the Tribunal, relying on Article 44 of the ICSID Convention, which grants ICSID tribunals the power to decide procedural questions not covered by the Convention or the Rules, concluded that it had the power to order the discontinuance of proceedings with respect to one party at its request when the other party did not object. The Tribunal found that permitting such discontinuance in this case was in accordance with the basic objective of the ICSID Convention of facilitating the settlement of investment disputes, of which ICSID Arbitration Rule 44 is a specific manifestation."
Ford Aerospace & Communications Corporation and Aeronutronic Overseas, Inc, Claimants, v The Air Force of The Islamic Republic of Iran, The Ground Forces of The Islamic Republic of Iran, The Ministry of Defense of The Islamic Republic of Iran, Bank Markazi Iran, And The Government of Iran, Case No. 159, 1983.

powers has positive and negative effects. Its effect at one end of the spectrum is to open the hands of arbitrators to redress power of the parties and to administer justice. On the other hand, it facilitates abuse and prejudice under the name of inherent power. Arbitrators have remarked upon and warned about this threat:

> "In the absence of any explicit text whatsoever, and instead of pursuing the natural course of adjudication – namely, dismissing the Claimants' motion – the majority in Chamber One has had recourse to a non-legalistic argument, adducing something by the name of the "inherent power" of the Tribunal to preserve its jurisdiction. The "inherent power" of a tribunal, if not supported by any confirmed and recognized legal text or rule of jurisprudence, is nothing other than the exercise of despotism and dictatorship; and this is something which has been prohibited by the laws of numerous nations, including Article 166 of the Constitution of the Islamic Republic of Iran." (Dissenting Opinion of Mahmoud Kashani Member of Chamber One of IUSCT, in *Rca Global Communicationsdisc, Inc. (Rca Globcom Disc), Rca Globcom Systems, Inc., v The Islamic Republic of Iran, Telecommunication Company of Iran, The Islamic Republic of Iran's, Army Joint Staff Bank Melli Iran, Bank Markazi, Foreign Trade Bank of Iran*, 1983) [96]

Therefore it is essential to establish a boundary to limit and control the exercise of inherent powers to the optimal objective, which is administration of justice. One may claim that those powers that "(*i)* aim at *regulating* the proceedings, or *(ii)* are *instrumental in the adjudication* of the main claim, or (*iii)* are designed to *safeguard the judicial character* of courts, do not need to be expressly provided for by a specific legal source"(Gaeta 2003, 368). Thus, based on this view, tribunals are limited in exercising inherent powers; they cannot exercise inherent powers without reference to legal sources, when they are not regulating the proceedings, or when the power they exercise is not instrumental for the claim, and when the aim of the powers is not to safeguard the judicial character of the tribunal. A further limitation is that the inherent powers cannot be exercised when they are in opposition with rules and conventions. In other words, the application of inherent powers is restricted by express powers.

[96] Dissenting Opinion of Mahmoud Kashani Member of Chamber One of IUSCT, *Rca Globcom Communications Inc. (Rca Globcom Inc.), Rca Global Communicationsdisc, Inc. (Rca Globcom Disc), Rca Globcom Systems, Inc., v The Islamic Republic of Iran, Telecommunication Company of Iran, The Islamic Republic of Iran's, Army Joint Staff Bank Melli Iran, Bank Markazi, Foreign Trade Bank of Iran*, Case No. 160, 1983

Applying Gaeta's three conditions above-mentioned, the arbitration tribunals' task of balancing power falls under the scope of the third condition, which is the exercise of inherent powers to safeguard the judicial character. When inherent powers are controlled and exercised in good faith, they can be regarded as valuable resources in promoting fair and effective dispute resolution particularly in relation to balance of power between the parties, and safeguards the judicial character of arbitration. For instance in *Noble Energy Inc, Machala Power Cia Ltda v Ecuador, Consejo Nacional de Electricidad*, the ICSID tribunal exercised inherent powers to deal with relevant claims in one proceeding, in order to promote and enhance fairness in resolution of disputes:

> "This same consideration is also sometimes articulated in terms of interest of justice or procedural or judicial economy. In this instance, there is no question that it is more efficient to deal with all the claims in one proceeding rather than to resolve them separately. It also appears fair to resolve all the disputes in one arbitration. It will avoid contradictions or inconsistencies on identical or related issues and, there is no reason to believe that the parties' procedural rights would be adversely affected by a single procedure." (*Noble Energy Inc, Machala Power Cia Ltda v Ecuador, Consejo Nacional de Electricidad,* 2008, para 193)

Thus the arbitrators possess different forms of power. The powers of arbitrators emerge from different sources and accordingly are in different forms. The objective of empowering the arbitrators is to confer them the authority to effectively resolve disputes and to deal with the power of the parties. The use of each form of power mainly depends on the circumstances, which the arbitral tribunals have the power to decide by drawing the line in each case. The following section examines the pertinent doctrines and principles that underpin the authority of arbitrators in respect to the power of the parties and effective conflict resolution.

Table 3: Substantive Powers of the Players

POWERS OF THE PLAYERS	***Political Power***	***Economic Power***	***Legal Power***
Host State	Political negotiation power Military Power	Resources Local market	Rule-making Expropriation Taxation Right to control access to resources Right to appoint arbitrators
Investor	Home state's support Lobbying with the home state	Capital Technology Know-how	Fair and equitable treatment Full protection National treatment MFN Non-discrimination Access to Arbitration against host states Right to appoint arbitrators
Arbitrator			Inherent powers Powers conferred by the parties Powers conferred by the Law

B. Powers of Arbitrators in Respect to Substantive Aspect of Conflict

The purpose of this part is to explore the role of arbitrators' powers with regard to the substantive aspect of conflicts. It is called substantive, as it is in regard to determination of rights, and duties – the bargaining phase – and exercise of those rights in the form of legal power – the performance phase. Thus the substantive aspect of conflicts is based on the powers that the investors and host states exercise in the bargaining and the performance phases, which were discussed in the previous chapter, and the role of arbitrators in respect to each of those phases will be examined in the two following sections.

The first section examines the role of arbitrators in regard to the bargaining phase. Initially, the necessity for redressing power imbalance by a neutral third party is examined from a theoretical approach. Then, the doctrine of inequality of bargaining power as an appropriate principle for redressing power imbalance in investment relationships is analysed.

The second section is allocated to the role of arbitrators with regard to the performance of investment phase; which entails the conflict of interest between investors and host states. First the role of arbitrators in considering the public interests in investment conflicts is examined. Then the proportionality principle as a pertinent principle in balancing the private and public interests of the investment parties will be analysed.

I. Role of Arbitrators in Respect to the Bargaining Phase

As discussed in Chapter 2 on the formation of investment, the investment agreement is a product of negotiation and thus bargaining power. The investment parties exercise political and economic power in order to define the scope of their rights and duties. The inequality of bargaining power has a significant impact on the investment agreement and thus it is necessary for the arbitrators to consider that inequality. Arbitration in general and investment arbitration in particular is a product of bargaining as well as continuation of bargaining. In other words, a factor that significantly affects the bargaining power of the parties is the presence of neutral third parties (Rubin and Brown 1975). The questions that this section intends to explore are first of all whether arbitrators can have a balancing role in respect to the inequality of bargaining power, and secondly how the exercise of power by arbitrators with respect to the inequality of bargaining power can be legally justified. With regard to the former, in the first subsection below it will be argued that based on the exchange theory, arbitrators, as neutral third parties, can have a balancing role in the investment relationship. Indeed the aim of this is to *justify the balancing role* of arbitrators. In respect to the latter question, it will be argued that arbitrators can balance the inequalities through their judicial powers and based on principles of equity; thus the second subsection below analyses the doctrine of inequality of bargaining power in the common law system and its applicability in investment arbitration which will *justify the legal base of exercise of power* of arbitrators in relation to inequality of bargaining power.

i. Redressing Power Imbalance of the Bargaining Phase

As examined in the second chapter power is a central issue in bargaining, and bargaining is the battle of powers to get what one wants; bargaining power demarcates the ability of the parties to influence the process of settlement favourable to their interests. The inequality of bargaining power, thus, significantly affects the investment agreement, and therefore misuse of power by the more powerful party might cause conflict. The greater the imbalance of power in an exchange relationship, the higher the risk of misusing power, and therefore the higher the probability of emergence of conflict (P. Blau 1964).

Imbalance of power requires balancing; “if power imbalance leads to actions by the advantaged actor that violate rules of justice, or if behaviors generate perception of injustice then power use will perpetuate imbalance, and disadvantaged actors will seek new strategies

to rebalance the exchange, if they can"(Turner 1998, 322). According to Emerson's theory of power and exchange, there are four mechanisms to redress power imbalances:
"1.WITHDRAWAL. Decreased motivational investment on the part of the weaker member.
2. NETWORK EXTENSION. Increased availability of goals for the weaker member outside the relation (extension of the "power network" through formation of new relations)
3. STATUS GIVING. Increased motivational investment on the part of the stronger member
4. COALITION FORMATION. Decreased availability of goals outside of the relation for the stronger member ("coalition formation, or "collapsing a power network)." (Emerson, 1964, p. 290)

According to the first method, *B* can reduce the level of his dependency over *A* and therefore balance the inequality. The link between dependence and power is opposite; as dependence on others decreases, individual power increases and consequently power inequalities can be balanced. Secondly, *B* can refer to other resource providers. Thirdly, status giving is the increase of the value of the resources that *B* possesses. Fourthly, coalition is a step further than the network extension. In coalition the aim is to control the power of the advantaged party (Emerson, 1962). It is worth noting that the extension of network is forming new relationships and decreases the power of the advantaged party whereas coalition and emergence of a group increases the power of the disadvantaged actor.

The balancing mechanism relevant to the investment arbitration relationship is coalition. At this stage of exchange relationship, a third actor – the arbitrator – enters the network of investment parties. The parties confer power on arbitrators in the form of authority. In the words of Emerson:

> "A person holding such authority is commissioned; he does not simply have the right to rule or govern – he is obliged to. Thus, authority emerges as a transformation of power in a process called "legitimation," and that process is one special case of balancing operation number four" which is coalition." (Emerson, 1962, p. 38)

The network of exchange relationship between arbitrators, host states, and investors is a form of negative connection rather than positive; "(a) The connection is positive if exchange in one relation is contingent on exchange in the other. (b) The connection is negative if exchange in one relation is contingent on nonexchange in the other" (Cook & Emerson, 1983, p. 277). According to the negative connection, there is a central position in the network that is

not contingent and linked to the other actors of the network; power in negatively related networks falls to the central position.

In the investment arbitration network, generally, the arbitrator should be in the central position and should be considered as the powerful actor because of his central position. However if the central position shifts from arbitrator to the other two actors (either the state or the investor), according to the positive connection maxim of the exchange theory, the powerful party is not the arbitrator, because he loses his centrality in this network and the actor who is in the central position is the powerful actor (See Figure 3). Thus arbitrators have the power and role to consider the bargaining power of the parties.

Redressing power imbalances of the parties increases the fairness of the arbitration process. To put this differently, a fair solution is not purely based on the agreement of the parties but is a solution that has regard to the inequalities of bargaining power of the parties. Fairness as a meaning of equity is one of the ways of optimizing the effectiveness of arbitration; effectiveness increases the legitimacy and confidence of the disputing parties to arbitration and therefore expands the usage of this institution. In other words, an equitable treatment of the parties, assures both the weak and the powerful party in referring their investment conflicts to arbitration. In this respect it is stated that

> "International investment law serves as a commitment mechanism that deals with the problem of the 'obsolescing bargain' – the fact that once the investor has made its investment in the host State, its bargaining power can rapidly diminish. In other words, international investment law provides a measure of comfort through binding standards and investor-State arbitration." (Newcombe 2011, 188)

The history of investment arbitration indicates that this means of dispute resolution is deployed as a way for redressing power inequalities in favour of investors and for protection of investors; furthermore the ability to persuade a state to consent to arbitration depends on the bargaining power of investors. Investment conflicts used to get resolved by national courts, or through diplomatic protection; resolution of investment conflicts by arbitration as direct claim of investors against states was deemed an advantage merely for the investor.

However, nowadays, states consent to arbitration more easily in order to attract foreign investors. Thus in circumstances where the host state is in a strong bargaining position – for instance if competition between the investors is high – the host state is able to bargain and

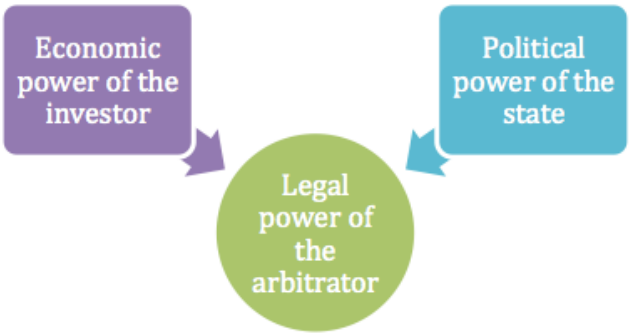
refuse to consent to arbitration. It is worth mentioning that despite the interest of the host states to resolve their conflicts with investors in their own national courts, the widespread use of arbitration in the field of foreign investment has rendered arbitration a common means of dispute resolution, which no longer is a mere advantage to the investors, and it also serves benefits to host states.

> "It is necessary for investment tribunals to give attention to the underlying "bargaining" between investor and host country and to ask whether each side is keeping to it. In essence that is what fair and equitable treatment is about: is the host country acting in accordance with the legitimate expectations created for the investor at the time the investment was entered into, thereby allowing the investor a reasonable opportunity to profit, and is the investor delivering, to the best standard of care and due diligence, the reasonably anticipated economic and other benefits of the investment? That would appear to encapsulate the true aims and purposes of investment treaties as they are currently drafted." (Muchlinski 2006, 556)

Consequently the conflicting parties, particularly in a foreign investment conflict, possess power and use that in order to dominate. Thus the process of conflict resolution is a game played around the orbit of the power of its actors: the arbitrator, the state, and the investor. In this game arbitral tribunals have crucial role, particularly to redress the power of the parties by their central and supreme power. As Thomas Wälde remarks, "Tribunals have a duty, if necessarily proactively, to restore "equality of arms" – a foundation principle of investment arbitration procedure" (Wälde, 2010, p. 180). The means available to investment arbitrators to redress power imbalances of the bargaining stage are their judicial powers – as discussed in the preceding section on 'Powers of Arbitrators'. The following subsection will suggest the doctrine of inequality of bargaining power as a legal framework that can justify the exercise of power by arbitrators to redress power imbalances.

Figure 3: Centrality of Power in Networks

Centrality of power in networks Exchange-Power Network of Investment Arbitration



ii. A Doctrine of Inequality of Bargaining Power in Investment Arbitration

On the basis of liberalism, which emphasises the supremacy of individual rights and the autonomy of the will, people are free to bind their freedom and conclude contracts. Unless proved otherwise, the general rule is that the contracting parties enter into agreements with absolute free will. According to the classical theorists of liberalism such as Hobbes, justice is what the parties agree upon and is "keeping of covenant" (Hobbes 1660). In other words, "no outcome of actual bargaining would be unfair" (Barry, 1989, p. 51). Therefore "an arbitrator should use (or at any rate should behave as if using) a solution concept that mimics the results of rational bargaining" (Barry, 1989, p. 51). A decision made on this basis is assumed to be just. This is the view that was predominant from the seventeenth until the twentieth centuries.

Notwithstanding, there are circumstances under which the mere contractual agreement cannot be a criterion for the assessment of justice, and in fact in some cases it may result in injustice. These exceptional circumstances vary in degree and effect. For instance when a contract is made under illegitimate conditions such as coercion, it by no means indicates the genuine consent of the parties and therefore cannot be a base for justice, and strict adherence to the contractual terms could have unjust consequences for the innocent party. However, not all unjust consequences have resulted from illegitimate means. Inequality of bargaining power might generate unfair effects.

Inequality of bargaining power of the contracting parties contradicts the general principle of liberalism and the autonomy of the will. In other words, in cases of asymmetrical power, although the weaker party voluntarily consents to the terms of the contract, the power of the dominant party may influence the subordinate in assenting to these terms. However the difference between contracts made by coercion and those made on the basis of inequality is that the latter are legally concluded but the former are illegitimate. It is claimed that

> "The law usually uses a two-pronged standard for this: it says that fraud and coercion nullify contracts, but allows for many other kinds of conditions, such as asymmetric information and unequal bargaining power, to influence contracts, as long as the beneficiary of the contract is not culpably responsible for these inequalities" (Brighouse 2004, 39).

Under English Law, the importance of the doctrine of inequality of bargaining power has been emphasised by Lord Denning:

> "There are cases in our books in which the courts will set aside a contract, or a transfer of property, when the parties have not met on equal terms – when the one is so strong in bargaining power and the other so weak – that, as a matter of common fairness, it is not right that the strong should be allowed to push the weak to the wall. Hitherto those exceptional cases have been treated each as a separate category in itself. But I think the time has come when we should seek to find a principle to unite them." (*Lloyds Bank Ltd v Bundy,* 1975, p. 337)

He further stipulates that:

> "the English law gives relief to one who, without independent advice, enters into a contract upon terms which are very unfair or transfers property for a consideration which is grossly inadequate, when his bargaining power is grievously impaired by reason of his own needs or desires, or by his own ignorance or infirmity, coupled with undue influences or pressures brought to bear on him by or for the benefit of the other"
> "Gathering all together, I would suggest that through all these instances there runs a single thread. They rest on "inequality of bargaining power." (*Lloyds Bank Ltd v Bundy,* 1975, p. 339)

The doctrine that Lord Denning suggests protects the weaker party's interests in a case of unequal bargaining power. Nonetheless Lord Denning's view on the existence of a 'doctrine of inequality of bargaining power' is not an orthodox and widely accepted principle in the common law system. The existence of other principles such as duress and undue influence restricts the need for a broader principle of inequality of bargaining power. It is worth noting that "although English courts have rejected the inequality of bargaining power doctrine in name, they have not thereby rejected the notion that at least some minimal degree of fairness is required to establish the validity of a contract" (Thal 1988, 33). To put it another way, fairness must underpin the principle of inequality of bargaining power or any rules relating to unconscionability (Mckendrick 2011).

Thus it can be inferred that even though there is no doctrine or a general principle of inequality of bargaining power in national as well as international law, "minimal degree of

fairness" is required in the contractual relationships and particularly investment including BITs and investment contracts. Accordingly the strict adherence to the freedom of contract might be redressed by some limitations in order to establish justice and fairness. In investment relationships the need for a general principle of inequality of bargaining power is more perceptible than other areas of law. This need is due to the central role of power in the formation and performance of investment contracts and treaties.

II. Role of Arbitrators in Respect to the Performance Phase

The aim of this section is to explore the role and powers of arbitrators in regard to the exercise of power by the investment parties after investment agreements – contracts or BITs – are formed, and the stage when the parties are exercising their legal powers and obligations.

As examined in the preceding chapter, during the performance of investment the intention of the parties is to reach their interests through their powers. Conflict of interests exists between investors and host states due to their nature – the state as an actor with public interests, and investors with private interests. The conflict of interests and imbalance of power between the investment parties may engender actual conflict. In other words, the majority of the investment conflicts that are known as *disputes,* are based on the legal problems in non-performing or mal-performing investment due to conflict of interests and power imbalance.

Thus it is essential for arbitrators to consider power imbalance as well as the conflict of interests, when resolving conflicts. In other words, arbitrators shall consider the roots of the conflicts. For this purpose, it is crucial to elucidate whether investment arbitrators can have any role in respect to conflict of interests between the parties. Thus, in the first subsection below, it will be further elucidated that arbitrators in investment conflicts have public and quasi-judicial roles.

Furthermore, it is important to find the legal basis that justifies the exercise of power on behalf of arbitrators in respect to the conflict of interests. Therefore, the second subsection will explore the pertinent principles – including proportionality and balancing principles – that arbitrators can use in order to effectively resolve investment conflicts with public matters involved.

i. Public Role of Arbitrators in Investment Conflicts

Originally, the purpose of arbitration was to protect investors from the political threats of host states' courts (Wolfgang 1995). Even nowadays international arbitration and particularly direct investor-state arbitration under investment treaties are deemed to be a remedy for the investors against the political powers of the host state. Accordingly it is claimed that this mechanism has not served host states and has been a device to further the interests of investors(Alvarez and Park 2003).

Nonetheless, host states have interests in resolving disputes by arbitration in order to attract foreign investment:

> "Because of its importance to development and economic prosperity, there is keen competition among developed and developing countries to attract foreign investment. Governments use various strategies at the national and sub-national levels to facilitate this objective. Some of these strategies might be straightforward, such as liberalizing an economic sector or providing tax incentives. Other strategies might be more complex, such as improving the court system or creating effective alternative dispute resolution mechanisms." (Franck S. D., 2007, p. 170)

The extent to which investment arbitration has been effective in satisfying both the states and investors depends on their ability to balance the rights and interests of the parties. "The right of the host State to adopt its economic policies together with the rights of investors under a system of guarantees and protection are at the very heart of this difficult balance, a balance which the [ICSID] Convention was careful to preserve" (*CMS Gas Transmission Co v Republic of Argentina,* 2005, p. 499). Thus, on the one hand, it is claimed that ICSID arbitration has balanced the public rights of states and private rights of investors. On the other hand, it is argued that

> "There must be a necessary balance and it is this balance that has been lost as a result of the total dominance of investment protection as the only objective of such arbitration. Built-in biases of arbitrators and the expansion of the system of arbitration created through treaties through interpretation of its provision will soon lead to the collapse of the system" (Sornarajah, 2006, p. 348).

Therefore, it is essential for investment arbitration to consider public interests of host states parallel to private interests of investors in order to enhance the legitimacy and effectiveness of the investment arbitration system; however, due to the specific nature of investment arbitration, this is not a straightforward issue.

International investment law and investment arbitration are at the border of the two fields of international commercial and public international law (Mills, 2011). The aim of the former is to resolve disputes and the private interests of the parties involved in arbitration, whereas the objective of the latter is resolution of disputes by considering the public interests and rights.

However it is claimed that arbitrators have not been able to consider public interests of the host states:

> "Arbitration is intended to be a neutral system but investment arbitration has emerged as a system that is administered by arbitrators who believe entirely in neoliberal values or are unable to understand the public law elements involved in investment disputes. Many arbitrators come from commercial backgrounds, without a prior experience of dealing with disputes involving sovereign states. These arbitrators are prone to extend notions of commercial dispute resolution without adequate consideration of public law issues involved in the dispute." (Sornarajah, 2006, p. 348)

What has been suggested is that "arbitrators must still adopt a balanced approach between the right of investors, and those of host States" (McLachlan, Shore and Weiniger 2007, 23). Arbitration tribunals can exercise the balancing task through their legal power and policies such as fairness and justice. They exercise the power of balancing interests and consequently power through different principles, most importantly proportionality.

ii. Proportionality & Balancing of Interests

The vague and general rights conferred on investors by BITs, and the lack of robust law illustrating these standards, empowers investors to restrict the power of host states. On the other hand, the sovereign power of the states authorizes them to limit the protective standards of investors for public purposes and interests of the host nation. In respect to this conflict of interest and power imbalance of the parties, arbitrators are considered as assessors of the balance between private and public interests of the disputing parties(Kingsbury and Schill

2009). Arbitrators shall have some measures available to them in order to assess the interests of the parties and balance them; for this purpose, principles, such as proportionality and balancing, can be used.

Principles, like rules, are a division of norms; they both deal with what ought to be done; nevertheless "*rules* are norms which are always either fulfilled or not" (Alexy, 2002, p. 48). Conversely, "Principles are *optimization requirements*" and "require that something be realized to the greatest extent possible given the legal and factual possibilities" (Alexy, 2002, p. 47). 'General principles of law' are at the outset 'principles' and therefore optimisation requirements. General principles are addressed in the Statute of the ICJ as one of the sources of international law.[97] However, these principles have a complementary role; they fill the gaps that are not filled by the treaties and customary international law – the two main sources of international law. To put it another way, the general principles of law are generally considered to be in the shadow of other sources, particularly BITs and customary international law. "The dramatic proliferation of investment treaties in the recent decades, as well as the significant increase of investment awards pronouncing numerous customary norms, explain the diminishing need to apply the residual rules drawn from general principles of law" (Hirsch 2011, 17).

The subjective and discretionary nature of these general rules opens the hands of arbitrators to any abuse under the name of general principles of law. In this respect it is argued that "General principles of law are a weak source of international law" (Sornarajah, 2010, p. 418) and arbitrators tend to choose general principles that are in favour of the investor (Sornarajah, 2010). Thus although it is true that general principles of law are optimisation precepts and can be used to promote effectiveness, due to their broad discretionary nature, they are open to be misused by arbitrators in favour of one party and against the other.

Notwithstanding, the misuse of these principles is at the stage of their application by arbitrators; in other words the nature of these principles is not discriminatory. It is even argued that "general principles of law are the expression of the intense interaction between national and international law. Rather than bringing about the formation of a third legal order,

[97] ICJ Statute, Article 38 (1)(c): "1. The Court, whose function is to decide in accordance with international law such disputes as are submitted to it, shall apply:
c. the general principles of law recognized by civilized nations;"

they play a significant role in the process of internationalisation and delocalisation of investment law" (Gazzini 2009). Therefore if applied fairly, the general principles of law can enhance the effectiveness of investment disputes and consequently investment arbitration.

General principles of law are vague and extensive in terms of identification. A general principle that is pertinent to the balancing of public and private interests of the investment parties is the proportionality principle. Proportionality is a general principle of law that is recognised by some legal systems;[98] it is a type of interpretation and is used as a mechanism of decision-making in cases where two interests are in conflict. It consists of three sub-principles: suitability (rational connection), necessity, and proportionality in a narrow sense (*stricto sensu*) (Barak, 2012) (Alexy, 2002).

The first element of the proportionality principle underlines the suitability of the measures taken to obtain the aim. It requires "a causal relationship between the measure and the objective pursued" (Jans 2000, 243). The concept of suitability is more flexible than the concept of indispensability and less flexible than the concept of usefulness (Jans 2000). Put it another way, a suitable measure is not indispensable; however it is more than useful to take that measure.

This component of the proportionality principle is applied in different investment cases; for instance the tribunal in *Tecmed v United States* asserts that "whether such actions or measures are proportional to the public interest presumably protected thereby and to the protection legally granted to investment, taking into account that the significance of such impact has a key role upon deciding the proportionality" (*Tecmed v United Mexican States,* 2003, para 122). And it continues: "There must be a reasonable relationship of proportionality between the charge or weight imposed to the foreign investor and the aim sought to be realized by any expropriatory measure" (*Tecmed v United Mexican States,* 2003, para 122).

The necessity requirement is concerned with the alternative measures that are less detrimental to the rights and interests of the other party and as effective as the measure taken. Necessity, in other words, justifies the measures undertaken.

The final element of the proportionality principle deals with balancing the importance of conflicting interests. Balancing "is a test balancing benefits and harm"; it is of significant

[98] The principle of proportionality has its roots in German Law.

importance in comparison to the other two elements of proportionality and it is sometimes equated with the umbrella principle of proportionality (Barak, 2012, p. 340). For instance in the investment relationship, the balancing test evaluates the benefits gained by the host states as a result of the exercise of regulatory power against the harm caused to investors in limiting their protective rights such as fair and equitable treatment.

Balancing "provides flexibility, enabling judges to adapt decisions to facts (rather than shoe-horning facts into rigid rules), and to fashion equitable judgments, reducing the losses of the loser as much as possible" (Sweet, 2010, p. 50). However, balancing has its own disadvantages; irrationality and subjectivity are the main objections to the balancing principle (Alexy, 2002). Habermas raises the objection that firstly the balancing principle is subjective and discretionary, therefore it is not a reliable principle; secondly its discretionary nature sacrifices the correctness and incorrectness, and establishes a rather blurred justification(Habermas 1996) (Alexy, 2005).

The fundamental concern in practice is the method of balancing the interests. In this regard balancing tests have been used. Balancing tests vary in a continuum of different degrees: basic, concrete and principled balancing (Barak, 2010). The *basic balancing test* is defined by Alexy as the balancing law: "The greater the degree of non-satisfaction of, or detriment to one principle, the greater must be the importance of satisfying the other" (Alexy, 2002, p. 102). He further illustrates the elements and stages of this principle as follows:

> "The first stage involves establishing the degree of non-satisfaction of, or detriment to, the first principle. This is followed by a second stage in which the importance of satisfying the competing principle is established. Finally, the third stage establishes whether the importance of satisfying the competing principle justifies the detriment to, or non-satisfaction of, the first." (Alexy, 2002, p. 401).

This test is highly abstract and general; it can merely be used as a guideline to lead arbitrators in balancing the interests of the conflicting parties. However in order to reduce the subjectivity and discretionary decision-making it is essential to set a rather more principled test in regard to investor-state conflict of interests along with the general test.

At the other end of the continuum is the *concrete balancing test*. According to this test, it is at the discretion of arbitrators as decision-makers to evaluate the detriment to one interest

versus the importance of the competing interest in every particular case. As opposed to the basic test, the concrete test is of low abstraction and is determined depending on the circumstances of the case (Barak, 2010). According to this test the arbitrator is not guided by general standards; it is the specific situations of each case that is determinant. The extremely broad discretionary nature of this test prevents the control of arbitrators in making decisions and therefore increases the risk of misusing the discretionary power.

The *principled balancing test* is suggested as an intermediate test to redress the deficiencies of the two aforementioned extreme tests of balancing (Barak, 2010). The core idea of the principled balancing test "translates the basic balancing rule into a number of principled balancing rules formulated at a lower level of abstraction than the basic balancing rule and at a higher level than that of the concrete balancing rule" (Barak, 2010, p. 12). Thus the principled balancing test is framed and limited by some standards and at the same time it is adapted to the relevant field of decision-making. Principled balancing is applicable to a set of similar circumstances.

As all the rights are not of equal importance and as there is conflict of interests between the disputing parties, it is desirable for the investment legal system to formulate a principled balancing test. The formulation of a principled balancing test should be designed for future BITs in order to prevent discretionary assessment by arbitrators, and to enhance transparency and predictability.

In investment arbitration proportionality has been used as a tool for arbitrators to assess the balance between the private interests of investors and the public interests of host states. The main function of proportionality is to *justify* the limitation of the interests and protective rights of investors – mainly fair and equitable treatment – against the public interests of the states – their regulatory power. Therefore proportionality balances the legal powers of the conflicting parties:

> "Thus in interpreting the meaning of "just" or "fair and equitable treatment" to be accorded to investors, the Tribunal must balance the legitimate and reasonable expectations of the Claimants with Argentina's and particularly the Province's right to regulate the provision of a vital public service. As the *Saluka* tribunal stated, "[t]he determination of a breach of Article 3.1 by the Czech Republic [which required fair and equitable treatment of investors] therefore requires a weighing of the Claimant's legitimate and reasonable expectations on the one hand and the Respondent's legitimate

> regulatory interests on the other.'" *(Suez, Sociedad general de Aguas de Barcelona S.A. and Interagua Servicios Integrales de Agua S.A. v. Argentine Republic,* 2010, para 216)

The advantage of proportionality in investment arbitration is conditional. "As long as sufficient leeway is given for the implementation of domestic policies, and as long as tribunals refrain from using it in order to establish an intrusive standard of review, proportionality analysis constitutes a concept that helps to counter fears about the dominance of investor rights over the interests of host states" (Schill 2011, 28).

Thus proportionality and the role of arbitrators as balancers of the interests – and powers – of the conflicting parties are intertwined with legitimacy and effectiveness of investment arbitration. Proportionality flows from "the rule of law or the essence of fundamental rights, and confers basic legitimacy on the system as a whole" (Sweet & Mathews, 2008, p. 26). The reason lies in the fact that "To the extent that the dispute resolver declares a winner, a two-against-one situation is created, which threatens to undermine the legitimacy of the proceeding and of the third party" (Sweet, 2010, p. 50); thus any balance of interests can satisfy both of the parties to believe in the fairness of the system. Therefore, theoretically it is of vital importance to maintain the balance in resolving disputes.

In practice *Tecmed v Mexico* (2003) is the first case that has addressed the principle of proportionality in the field of international investment by capturing the conflict of interests between the investors' private rights and public interests of the host state. In this case the claimant allegations are classified in an array of three claims:

> "1) The obligation to refrain from expropriating or nationalizing in violation of the Agreement; 2) The obligation to assure fair and equitable treatment in accordance with international law; and 3) The obligation to grant full security and protection to investments under international law, and the other violations to the Agreement alleged by the Claimant." *(Tecmed v United Mexican States,* 2003, para 94)

The claims are based on the rights of the investor; these rights confer the investor the power – in its legal type – to reach the private interests. These interests are in conflict with the public interests of the host state. The host state uses its legal power to reach its public interests. As for the first claim – expropriation – the respondent alleges that the measure under review

> "was a regulatory measure issued in compliance with the State's police power within the highly regulated and extremely sensitive framework of environmental protection and public health. In those circumstances, the Respondent alleges that the Resolution is a legitimate action of the State that does not amount to an expropriation under international law." (*Tecmed v United Mexican States,* 2003, para 97)

The tribunal admits that it is undisputable that in exercising its police power, including its regulatory power, the host state is not bound to pay compensation.[99] In other words police power is not under the scope of expropriation:

> "The principle that the State's exercise of its sovereign powers within the framework of its police power may cause economic damage to those subject to its powers as administrator without entitling them to any compensation whatsoever is undisputable". (*Tecmed v United Mexican States*, 2003, para 119)

However in balancing the interests of the conflicting parties when the tribunal clarifies the concept of the term 'expropriation', it refers to the ruling of the *Metalclad* tribunal on expropriation, which defines it as:

> "not only open, deliberate and acknowledged takings of property, such as outright seizure or formal or obligatory transfer of title in favour of the host State, but also covert or incidental interference with the use of property which has the effect of depriving the owner, in whole or in significant part, of the use or reasonably-to-be-expected economic benefit of property even if not necessarily to the obvious benefit of the host State." (*Metalclad v. United Mexican States*, 2000, para 103)

And finally the tribunal concludes that

> "we find no principle stating that regulatory administrative actions are per se excluded from the scope of the Agreement, even if they are beneficial to society as a whole — such as environmental protection—, particularly if the negative economic impact of such actions on the financial position of the investor is sufficient to neutralize in full the value, or economic or commercial use of its investment without receiving any compensation whatsoever." (*Tecmed v United Mexican States*, 2003*,* para 121)

[99] "The police powers doctrine recognizes that a State has the power to restrict private property rights without compensation in pursuance of a legitimate purpose." (Kingsbury & Schill, 2009, p. 32)

Therefore the tribunal expansively interprets the concept of expropriation, which consequently confines the regulatory power of host states. After defining the scope and position of the regulatory power, the tribunal addresses the principle of proportionality as follows:

> "After establishing that regulatory actions and measures will not be initially excluded from the definition of expropriatory acts, in addition to the negative financial impact of such actions or measures, the Arbitral Tribunal will consider, in order to determine if they are to be characterized as expropriatory, whether such actions or measures are proportional to the public interest presumably protected thereby and to the protection legally granted to investments, taking into account that the significance of such impact has a key role upon deciding the proportionality." (*Tecmed v United Mexican States*, 2003*,* para 122)

In other words, the tribunal correctly illustrates the conflict of interests between the conflicting parties and the necessity to balance it. However, in assessing the importance of the rights of the parties – applying the principle of proportionality – the tribunal puts greater emphasis on the individual rights of the investor; this is mainly due to the extensive interpretation of the definition of expropriation provided by the tribunal that encompasses regulatory power of the state.

> "There must be a reasonable relationship of proportionality between the charge or weight imposed to the foreign investor and the aim sought to be realized by any expropriatory measure. To value such charge or weight, it is very important to measure the size of the ownership deprivation caused by the actions of the state and whether such deprivation was compensated or not. On the basis of a number of legal and practical factors, it should be also considered that the foreign investor has a reduced or nil participation in the taking of the decisions that affect it, partly because the investors are not entitled to exercise political rights reserved to the nationals of the State, such as voting for the authorities that will issue the decisions that affect such investors." *(Tecmed v United Mexican States*, 2003, para 122)

The application of this principle by arbitral tribunals, particularly as a result of the judicial precedent of *Tecmed,* has prompted some scepticism about the neutral nature of the principle. The proportionality principle in the context of investment cases is perceived as a

pro-investor principle that can serve the private interests of investors along with other protective principles such as fair and equitable treatment.[100] Notwithstanding, the mere principle of proportionality is an optimisation principle with ample potentiality to balance the interests of the conflicting parties. More importantly it can be a useful tool with far reaching impact in enhancing the legitimacy and effectiveness of investment arbitration. Therefore the onus is on the arbitrators to apply the principle of proportionality in an appropriate way by placing a higher level of significance on recognising the importance of public interests of host states. To put this another way, the importance of public interests of host states are related to the interests of its nation and therefore should not be considered equal to private interests of investors. The consequence of continuing the misuse of the principle of proportionality is to undermine the legitimacy of the investment arbitration system as a whole.

Another example of proportionality in international investment is *LG&E v Argentine.* The tribunal in this case recognises the power of the state to regulate for public purposes as a non-compensatory power:

> "With respect to the power of the State to adopt its policies, it can generally be said that the State has the right to adopt measures having a social or general welfare purpose. In such a case, the measure must be accepted without any imposition of liability, except in cases where the State's action is obviously disproportionate to the need being addressed." *(LG&E Energy Corp., LG&E Capital Corp., LG&E International Inc. v. Argentine Republic,* 2006, para 195)

In *LG&E* the tribunal held that based on the proportionality principle the regulatory measure of the host state is not expropriation. Therefore, generally the host state has the power to regulate without being liable for compensation; nonetheless, this power is subject to the proportionality principle. If the regulatory measure of the state passes the test of proportionality, the investor is not entitled to compensation.

> "a State is not responsible for loss of property or for other economic disadvantage resulting from bona fide general taxation or any other action that is commonly accepted as within the police power of States, provided it is not discriminatory and is not

[100] For instance, the results of most of the Argentine Investment Cases indicate the pro-investor use of the proportionality principle.

designed to cause the alien to abandon the property to the State or to sell it at a distress price." *(Too v. Greater Modesto Insurance Associates,* 1989, para 26)

As a concluding remark, it is of particular interest to note that the aim of investment and BITs is not merely to protect the investors. Although it has been notoriously perceived – particularly by investors and some arbitrators – that BITs are to protect investors, as it is mentioned in BITs, economic development of the host state is an essential limb of investment. Hence the first step in balancing is to consider BITs as a *mutual* legal instrument and interpret it in good faith. The second step in balancing is to control the subjective nature of the proportionality principle by defining the scope of the general rights of the investors against host states in the BITs more specifically and more in detail. By this technique, the risk of any misuse of discretionary power of arbitrators is confined and the proportionality principle can be used as a means to optimise the effectiveness and legitimacy of the investment system.

C. Powers of Arbitrators in Respect to Procedural Aspect of Conflict

The preceding part studied the role of arbitrators in regard to the substantive aspect of investment conflicts, and the exercise of power by the parties during the formation and performance of investment. This part underlines the powers of arbitrators in respect to the procedural aspect of investment conflicts.

The investors and host states – and particularly their lawyers – can influence arbitrators and their decisions by exercising power over the process of conflict resolution. In order to resist the influence of the conflicting parties' powers, arbitrators shall abide by the principles of the rule of law: the principles of equality before the law, impartiality and independency, and procedural justice. Put differently, investment arbitrators should exercise their function according to these three principles of the rule of law.

The rule of law and its effects are important issues with respect to power and are consequently dealt with in the next chapter; nonetheless, here it suffices to address the fact that the rule of law is essential for the legitimacy and effectiveness of investment arbitration and the international investment system in general. Chapter 4 explores the concepts of the rule of law, legitimacy, effectiveness, and their interconnections.

This part of Chapter 3, however, is allocated to the analysis of the three principles of equality before the law, impartiality and independence, and procedural justice, as the constituting elements of the rule of law and as the necessary conditions for the role of arbitrators in respect to procedural aspect of conflicts.

I. Equality Before the Law

The precept of equality before the law is a foundational principle of the rule of law. Equality before the law denotes that no person has special legal privileges over others and everyone is equal in the eyes of the law. As the UN Universal Declaration of Human Rights declares "All are equal before the law and are entitled without any discrimination to equal protection of the law" (UN Universal Declaration of Human Rights n.d.). All persons shall be treated equally irrespective of their political, economic and cultural positions, their race, language and opinions.

Arbitration rules and conventions address the principle of equality before the law. For instance Article 15 of the IUSCT Rules of Procedures (modelled from UNCITRAL Arbitration Rules) provides that:

> "Subject to these Rules, the arbitral tribunal may conduct the arbitration in such manner as it considers appropriate, provided that the parties are treated with equality and that at any stage of the proceedings each party is given a full opportunity of presenting his case."

According to equality before the law principle or as it is also called the formal equality, judges and arbitrators shall treat the conflicting parties equally in applying and enforcing the law (Dworkin 1998). Equality before the law is a guard against discretionary application of the law as well as discrimination by arbitrators, and all the authorities in charge for application and enforcement of the law. Discrimination is a prejudicial behaviour on a non-rational basis. It connotes that arbitrators treat the parties unequally, by favouring a party and/or excluding the other. Discrimination is related to impartiality of arbitrators, which is another principle of the rule of law and will be discussed further in the following section. For the present purpose, it suffices to consider the principle of equality before the law as a block against discrimination.

In the context of investment, authorities that apply the law including arbitrators, have the duty to treat the disputing parties equally disregarding their economic and political powers. Whether a party of an investment dispute is a powerful host state possessing military, political, and economic power, or an MNE with considerable economic leverage and the

political support of the home state, they are equal in the eyes of the law and arbitrators shall resolve conflicts without considering their status and more importantly their powers. Therefore equality before the law thwarts the power of the parties to influence the legal process of dispute resolution.

Although the principle of equality before the law is crucial for the application of the rule of law, the question is whether strict adherence to equality can guarantee justice and fairness in the process of resolving disputes between unequal powers. In other words, if arbitrators treat parties with unequal powers, equally – which is in fact their duty – will the result be fair? Can arbitrators deviate from the equality principle to ensure fairness and justice?

"Liberal legalism creates a façade of neutrality and formal equality that masks and perpetuates real economic and social inequality" (B. Tamanaha 2002, 9). In cases where the disputing parties are not identical in terms of their powers, the formal equality model tends to perpetuate inequality. Thus it can be argued that treating unequal parties equally, when there is a rational basis to treat them unequally, is a form of discrimination. Accordingly rigid equality before the law may in some cases engender injustice; however there must be rational justification of fairness for any unequal treatment. Thus in some circumstances there might be confrontation between adherence to the equality before the law principle and the precept of justice.[101]

As Professor Sornarajah stipulates, "...justice is the refuge of the weaker States whereas power is the weapon of the stronger States as well as stronger entities in the process of globalisation that is currently afoot" (Sornarajah, 1997, p. 106); but what exactly justice means in regards to investment arbitration is a challenging issue. Rawls's theory of justice as one of the most renowned theories will now be considered in order to discern the notion of justice in investment arbitration. In this aim, first the structure and main pillars of the theory should be examined to test its applicability to the subject of investment arbitration.

The structure of Rawls's theory of justice is mainly composed of (a) 'the subject of justice' and (b) 'the principles of justice'(Rawls 1999). According to Rawls's theory, the subject of justice is the 'Basic Structure'. The Basic Structure "consists of some of the

[101] Justice is an extremely complex theoretical concept and it will be examined to the extent that can serve the purpose of the present subject.

central, interaction-shaping institutions of a society: for example, the constitution, the legally recognized forms of property, the structure of the economy, the design of the parliament, and the judiciary" (Brighouse 2004, 36). The 'judiciary' entails any judicial system including arbitration. Therefore arbitration as a basic structure is a subject of justice. In other words, arbitration is an institution that should be based on the principles of justice and should administer justice.

The principles of justice, according to Rawls's theory, are liberty and the difference principle. In the words of Rawls the principles of justice are classified as follows:

> "First: each person is to have an equal right to the most extensive scheme of equal basic liberties compatible with a similar scheme of liberties for others.
>
> Second: social and economic inequalities are to be arranged so that they are both (a) reasonably expected to be to everyone's advantage, and (b) attached to positions and offices open to all" (Rawls 1999, 53).

The first part of the latter principle is related to the present subject and therefore will be examined. This principle concerns the principle of equality and the difference principle. The traditional belief was that equality is equivalent to justice. A passage from Aristotle elucidates the original belief on the link between equality and justice:

> "Therefore the equal is intermediate between the greater and the less, but the gain and the loss are respectively greater and less in contrary ways; more of the good and less of the evil are gain, and the contrary is loss; intermediate between them is, as we saw, equal, which we say is just; therefore corrective justice will be the intermediate between loss and gain. This is why, when people dispute, they take refuge in the judge; and to go to the judge is to go to justice; for the nature of the judge is to be a sort of animate justice; and they seek the judge as an intermediate, and in some states they call judges mediators, on the assumption that if they get what is intermediate they will get what is just. The just, then, is an intermediate, since the judge is so. Now the judge restores equality; it is as though there were a line divided into unequal parts, and he took away that by which the greater segment exceeds the half, and added it to the smaller segment. And when the whole has been equally divided, then they say they have 'their own'-i.e. when they have got what is equal. The equal is intermediate between the greater and the

> lesser line according to arithmetical proportion. It is for this reason also that it is called just (sikaion), because it is a division into two equal parts (sicha), just as if one were to call it sichaion; and the judge (sikastes) is one who bisects (sichastes)." (Aristotle, 2007, p. 79).

On the basis of Rawls's theory, justice is not necessarily equivalent to strict equality. In cases of inequality, justice implies that any inequality should be to 'everyone's advantage'. Rawls interprets 'everyone's advantage' as the 'difference principle', which connotes that any inequality should be to the greatest benefit of the least advantaged (Brighouse 2004). In other words, the general principle is equality; inequalities are allowed merely when they benefit the least advantaged (Rawls 1999). Rawls believes that everyone is better off under the 'difference principle' rather than under the strict equality; "under the Difference principle every position is either better off than every position under strict equality, or every position is identical to every position under strict equality" (Brighouse 2004, 53). Therefore the difference principle is more advantageous to the parties than the strict equality.

Applying Rawls's theory of justice to the context of investment arbitration and equality before the law, it can be conceived that when resolving conflicts, arbitrators should treat conflicting parties equally. When the conflict is between parties with equal power the general rule of the principle of equality before the law will be applied. However, between unequal powers, the equal treatment may amplify inequality of the parties and lead to unjust consequences. Thus based on the difference principle, arbitrators should administer justice by interpreting the terms in favour of the least advantaged particularly when there are signs of exercise of power in an excessive way by the powerful party. Only in this case it is rational to treat unequal parties unequally.

II. Independence & Impartiality

The second principle of the rule of law consists of two essential principles: impartiality and independency. “Every arbitrator shall be impartial and independent of the parties at the time of accepting an appointment to serve and shall remain so during the entire arbitration proceeding until the final award has been rendered or the proceeding has otherwise finally terminated” (The IBA Guidelines on Conflicts of Interest in International Arbitration, 2004, General Principle 1). Independence and impartiality are interconnected to power. These two principles are generally used together, however they are different.

i. Independency

Delegation of power to international adjudication in general and international investment arbitration in particular encompasses two opposite notions: control and independence. The more control and influence by the parties on investment arbitration the less the independence and credibility of the tribunal(Robers 2010). Accordingly, independency of the investment arbitrators can be affected from two dimensions of power of the parties: political influences of the government and the economic influences of the investors (Van Harten, 1969).

The results of judicial independence are to administer justice in the resolution of disputes and to increase the public confidence in the justice system (Van Harten, 2010). This issue is common to adjudication in courts and by arbitration; however the distinctive feature of arbitration and court adjudication is the mechanisms for securing impartiality and independency (Van Harten, 2010). One way of guaranteeing independency of judges is by the security of tenure.

> “The absence of security of tenure (as well as other objective guarantees) in investment treaty arbitration is important because it suggests that the system will tend to favor claimants (that is, investors) and disfavor respondent governments, especially those governments that do not wield significant power within the appointments process and that do not have other ways to apply pressure to arbitrators” (Van Harten, 2010, p. 441).

The nature of investment arbitration leads to the conclusion that the parties control investment arbitration and thus arbitration is not an independent mechanism and consequently

the rule of law fails to apply. The reasons are held to be "that arbitrators lack security of tenure and that the system is one-sided in that it allows only investors to bring claims and requires only states to pay damages for treaty violations" (Van Harten, 2010, p. 167). As for the former – security of tenure – arbitrators are appointed on a case-by-case basis and therefore their mission is temporary for a specific dispute. The appointing authorities generally are either arbitration institutions (or institutions that are authorised by the disputing parties to appoint arbitrators) or prospective claimants (mainly investors). Both appointing groups tend to act in favour of promotion of the investment arbitration market so to increase the reference of investment disputes to arbitration. The appointing authorities possess significant powers in appointing an arbitrator in investment disputes. They have power to appoint the presiding arbitrator and the sole arbitrator – when the parties fail to agree. In ICSID arbitration, the Centre has the power to appoint a member of the annulment tribunals. The appointment of arbitrators in ICSID is commonly exercised by either the Chair of the ICSID Administrative Council or by the ICSID Secretary General, both chosen by the US and other capital exporting countries. "At present investment treaty arbitration appears at times to be a rather one-sided and mercenary affair, and this can and should be changed for the benefit of the system and the interests it is meant to balance and protect" (Van Harten, 2010, p. 453). As it is argued, "without robust guarantees of independence in the resolution of public law, adjudication is stripped of its defining claims to fairness and accuracy" (Van Harten, 2010, p. 453) and therefore host states need to claim against this indirect exercise of power in favour of investors.

Moreover, as there is no judicial review and appellate body in investment arbitration the awards issued by arbitrators are less likely to be reviewed and reconsidered by a higher level controlling body. The stated reasons have led to the conclusion that "Arbitrators are members of an industry the purpose of which is to supply adjudicative services in exchange for (lucrative) remuneration" (Van Harten, 2010, p. 173). When arbitrators are appointed on a case-by-case basis, they cannot be independent and impartial and consequently there can be no rule of law without an independent judiciary (Van Harten, 2010). Consequently it is claimed that the system of investment arbitration does not satisfy the requirement of judicial independence in public law (Van Harten, 2010).

As Sornarajah remarks:

> "Arbitrators, persons, whom the world is led to believe, are of high eminence, go to bat for the big boys, simply because they will not get any further lucrative business if they do not decide in the only "right" way that ensures their continuance in business. This charade can be expected to continue, especially in the context of institutional arbitration where the disturbance of established trends by any independent-minded arbitrator will result in his future ostracism from the system" (Sornarajah, 1997, p. 118).

In order to further illustrate the concept of independency and its relation to effectiveness, it is worth exploring it through existing polemics. The debate is whether independent tribunals or dependent tribunals are more effective. There are two schools of thought on the relation between independence and effectiveness of international adjudication.

On the one hand the proponents of the first group believe that there is "no evidence that independent tribunals are more effective than dependent tribunals" (Posner and Yoo 2005, 29). They define an independent tribunal as a tribunal of which "its members are institutionally separated from the state parties – when they have fixed terms and salary protection, and the tribunal itself has, by agreement, compulsory rather than consensual jurisdiction" (Posner and Yoo 2005, 7). The core logic of their argument is that independent tribunals may act against the interests of the disputing parties and may not be satisfactory to them; consequently they may be neglected, weakened and finally eliminated. Therefore, according to this group, independence is not a precondition of effectiveness.

The difference between the nature of domestic and international adjudication leads this group to justify that at the international level the relation between independence and effectiveness is not as correlated as it is in the domestic courts. Domestic courts particularly in democratic countries are independent; judges have security of tenure and specific salaries; they are not appointed for a specific dispute and for a specific period. Therefore they are not dependent on the disputing parties to be appointed. According to this view:

> "In sum, independence is a measure of a tribunal member's vulnerability to the state that appoints him. Tribunal composed of dependent members have a strong incentive to serve the joint interests of the disputing states. Tribunals composed of independent members have a weaker incentive to serve those states' interests and are more likely to allow moral ideals, ideological imperatives, or the interests of other states to influence their judgments" (Posner and Yoo 2005, 27).

For this group the effectiveness of dispute resolution outweighs its applicability to the rule of law as well as legitimacy. To put it another way opponents of independency undermine the importance of the rule of law and underline merely the effectiveness; they sacrifice the rule of law for effectiveness. The concepts of legitimacy and effectiveness and their relation with the rule of law merit extensive investigation and will be discussed in the following chapter. For now it suffices to elucidate that the precepts of rule of law and its relevant principles including equality before the law, independency and impartiality, and procedural fairness are entwined with legitimacy and effectiveness. The lower the degree of independency of arbitrators, the lower the degree of the application of the rule of law to arbitration system; the rule of law is one of the sources of legitimacy and therefore any decrease of the rule of law results the decrease of legitimacy of arbitration. Legitimacy and effectiveness are interweaved. When legitimacy diminishes, in the passage of time effectiveness reduces too. Therefore the claim that dependency of arbitrators increases the effectiveness of the arbitration system can be rejected through the line of reasoning of the rule of law, legitimacy, and effectiveness.

The opposite view favours the independency of international adjudicators including arbitrators. According to this view, as independent tribunals make decisions on the basis of principles rather than power they are more effective (Helfer and Slaughter 1997). The proponents of this view believe that "independence at the international level, like independence at the domestic level, is the key to the rule of law as well as the success of formalised international dispute resolution" (Posner and Yoo 2005, 7). The logic of independence in the domestic sphere can be applied at the international level and therefore it can be concluded that legitimacy might be achieved by granting independence to international adjudicators such as domestic judges (Posner and Yoo 2005). Although the core idea of the latter view is rational-based and more pertinent to the present subject, it is not entirely compatible with the line of reasoning based on power.

The two opposing views on the issue of independency of arbitrators can be synthesised from a power dynamic perspective. Recall from the definition of power based on dependency theory, power of A over B is the dependency of B on A. When an actor (B) is dependent on another (A), A possesses power and can benefit from its position to influence and exert power. Dependency of arbitrators on the parties results in the subordination of arbitrators and superordination of the party on whom the arbitrator is dependent. In this case the arbitrator

and in fact the legal power of arbitrators becomes an ancillary means for the powerful party to use arbitration to exert more power.

Furthermore, dependency of arbitrators on the conflicting parties, result in accepting that investment arbitration is an interplay of three players with conflict of interests; put differently, in the resolution phase the interests of investors, host states and arbitrators interface and each exercises power to attain personal interests. In light of this reasoning it can be perceived that dependency can be a means for rule *by* law. The rule of law, which is the supremacy of legal power over the power of the parties[102], cannot be reconciled with the dependency of arbitrators, which is the power of one party over the arbitrator. The prerequisite of the rule of law is the superiority of legal power and for that the arbitrator must be independent of and unaffected by power of the parties. Therefore the standpoint that argues in favour of the dependency of arbitrators can be rejected from the approach of power analysis and it can be justified that arbitrators, and in a general sense adjudicators, must be independent in order to avoid the risk of exercise of power by the dominant party and secure the application of the rule of law. The rule of law leads to legitimacy of the arbitration system. Legitimacy, in the long term, results in effectiveness. Thus it can be deduced that independency of arbitrators is an element that can increase the effectiveness of arbitration.

ii. Impartiality

In light of the common tendency to associate investment arbitration with the rule of law, an essential connector is impartiality of arbitrators. A fundamental principle that emerges from the rule of law is that arbitrators must be unbiased; they should have no tendency in favour of or against one party and must be neutral. The person in authority, such as the arbitrator, must dictate the principles of law and not his personal interests. This is in fact the initial conception of the rule of law, that the law should be dominant and as Hayek stipulates laws should rule and not men (Hayek 2011). "Judges are supposed to be unmoved by personal interests or the congeniality or otherwise of those who appear before them" (Barry, 1995). Nevertheless, there is always the risk of arbitrators' personal interests affecting their duty to apply the law. Their appointing mechanism amplifies the concern about partiality of arbitrators. As in most of the cases arbitrators are appointed by the parties – or at least there is the opportunity for the parties to appoint their own arbitrators even if they fail to appoint –

[102] The concept of the rule of law will be further explained in the following chapter.

and as the parties confer power to arbitrators, so there is a scepticism that the arbitrators' role is to support the parties that have appointed them. For instance based on ICSID rules that are exclusively investment related, each party appoints one arbitrator and the parties agree on the third arbitrator. They are dependent on the parties for their future employment. Thus they should satisfy the parties for the purpose of their security of tenure. This dependency of arbitrators on the parties – as examined in the preceding subsection – may lead to their partiality in favour of the party that appoints them. Therefore the dependency of arbitrators can result in prejudicial decision-making. The more dependent the arbitrator is on the parties, the more likely he is to decide not on the basis of law but based on personal favours. In this sense the arbitrator's role would be similar to a lawyer who is an agent that acts in the best interest of the appointing party, whereas the role of an arbitrator ought to assimilate with the role of a judge: "a role in which impartial conduct is demanded" (Barry, 1995, p. 13). Thus ruling according to personal interests of arbitrators, as has been asserted, "poses the spectre of the usurpation of power by an unaccountable elite, treating political issues as if they were matters of law, hiding political decisions under the guise of purely legal interpretations" (Tamanaha B. Z., 2004, p. 125). Notwithstanding, in exerting their power, arbitrators ought to be pro investment, and not pro-investor or pro-state (Cheng 2005). Although theoretically impartiality is a necessary condition for any system, including investment arbitration, in practice it is no easy task to ensure it. Laws are abstract rules and must be applied by the authorities and experts; arbitrators and judges are experts and actors with legitimate power to apply the law to the facts. In the process of the application of the law the reasoning and insight of arbitrators from the law is critical. This is a dilemma between application of the law and application of subjective interests under the name and cover of law. "This large difference is appropriately captured by the contrast between rule of law and rule of man" (B. Z. Tamanaha 2004, 125). Rule of man – or rule by law – is arbitrary decision-making. Raz elucidates the notion of arbitrary power:

> "Arbitrary power is a difficult notion. We have no cause to analyse it here. It seems, however, that an act which is the exercise of power is arbitrary only if it was done either with indifference as to whether it will serve the purpose which alone can justify use of that power or with belief that it will not serve them" (Raz, 2009, p. 219).

Two intuitive factors are fundamental in determining arbitrary decisions and in fact differentiating between the rule of law and the rule by law in the procedure of dispute

resolution by arbitrators as well as judges: interpretation and the requirement of good faith. Recall that interpretation is one of the legal powers that arbitrators possess. As laws are enacted in a general framework to enhance justice, interpretation is a medium in the hands of arbitrators to apply the law by considering the facts in order to administer justice on a case-by-case basis. As Rawls states, "if the rules are at all complicated and call for interpretation, it may be easy to justify an arbitrary decision. But as the number of cases increases, plausible justifications or biased judgments become more difficult to construct" (Rawls 1999, 209). Furthermore "the precept that like decisions be given in like cases significantly limits the discretion of judges and others in authority" (Rawls 1999, 209). However as in investment arbitration the rule of precedent has no application, the forfeiture of this precept increases the likelihood of arbitrary decisions – at least more than adjudication through courts.

The precept of good faith confines the extensive scope and amorphous nature of interpretation. The Vienna Convention establishes that "the principles of free consent and of good faith and the pacta sunt servanda rule are universally recognized" (Vienna Convention on the Law of Treaties 1969). Based on the international conventions and treaties in fact "all parties to arbitration, including lawyers, the arbitrators, the arbitration institution (if chosen) and the actual disputing parties themselves must enter into the arbitration with a mutual obligation to act in good faith." (Tetley, 2004, p. 48). Arbitrators – and authorities that apply the law – in particular shall act in accordance to the principle of good faith (Rawls 1999).

Although good faith can be a check against discretionary power of arbitrators in interpreting the rules and agreements, the term 'good faith' is itself loose and subjective. Good faith is related to principles such as honesty, fairness and reasonableness (Tetley, 2004) and therefore can be described as a reasonable and fair application of law. Arbitrators ought to act based on reasonable justifications and in accordance to fairness in interpreting and applying the rules. Notwithstanding from the perspective of the weaker party, it is even more advantageous to refer to a biased arbitrator. A biased arbitrator with good faith will exert his power impartially in favour of the weaker in order to balance the power asymmetries between the parties. So long as the outcome is just and the arbitrator's bias is based on the precept of good faith, bias in this sense is not generally objectionable by either party. However this is a delicate and risky claim. It can easily turn to the abuse of power by arbitrators; hence good faith is essential in order to prevent any abuse and transform bias to effective results.

III. Procedural Justice

The dispute resolution system is primarily a matter of procedure. Procedural justice is concerned with the fairness of dispute resolution processes.[103] Accordingly, arbitration as a system of dispute resolution is entwined with procedural justice. On the other hand, procedural justice is one of the precepts derived from the rule of law. The conformity to the rule of law is necessarily linked to procedural justice. The concept of justice and accordingly procedural justice are discussed in chapter 1; the aim here is to examine procedural justice in investment arbitration and with regards to the rule of law.

The primary incentive for procedural justice stems from the interference of the state power, and the need for immunising the decision-making systems, including the courts and arbitral tribunals from inappropriate influences. (Van Harten, 2010). It impliedly connotes that the law should be dominant and that procedural justice is one of the multiple threads for this purpose. The precept of procedural fairness consists of 'the right to a fair hearing' (*audi alteram partem: hear the other side*) and 'the rule against bias' (*nemo iudex in causa sua*). In the scholarly definitions of the rule of law these aspects of procedural justice are significant. For instance, in developing the concept of the rule of law, Raz mentions the two principles of procedural fairness: "Open and fair hearing, absence of bias, and the like are obviously essential for the correct application of the law" (Raz, 2009, p. 218). Moreover, 'fairness in the application of the law' is the essential element of the UN, IBA and OECD definitions of the rule of law.[104]

The duty to treat the parties fairly is a duty, which is imposed on arbitrators expressly and impliedly by national laws and international law. Section 33 of the English Arbitration Act 1996 states that:

"(1) The tribunal shall–

(a) Act fairly and impartially between the parties, giving each party a reasonable opportunity of putting his case and dealing with that of his opponent, and

[103] Due process is another theoretical concept that is sometimes used interchangeably with procedural justice in some texts particularly in the US legal systems. In the words of Rawls "the rule of law requires some form of due process: that is, a process reasonably designed to ascertain the truth, in ways consistent with the other ends of the legal system, as to whether a violation has taken place and under what circumstances" (Rawls, 1999, p. 210)

[104] Different definitions of the rule of law are scrutinised in the following chapter.

(b) Adopt procedures suitable to the circumstances of the particular case, avoiding unnecessary delay or expense, so as to provide a fair means for the resolution of the matters falling to be determined

(2) The tribunal shall comply with that general duty in conducting the arbitral proceedings, in its decisions on matters of procedure and evidence and in the exercise of all other powers conferred on it."

According to the Vienna Convention "disputes concerning treaties, like other international disputes, should be settled by peaceful means and in conformity with the principles of justice and international law" (Vienna Convention on the Law of Treaties 1969).

Moreover, according to the Arbitration Rules of ICSID, any ICSID arbitrator should sign a declaration before or at the tribunal as to these terms:

"I shall judge fairly as between the parties, according to the applicable law, and shall not accept any instruction or compensation with regard to the proceeding from any source except as provided in the Convention on the Settlement of Investment Disputes between States and Nationals of Other States and in the Regulations and Rules made pursuant thereto."

This declaration is binding to the arbitrators and "Any arbitrator failing to sign a declaration by the end of the first session of the Tribunal shall be deemed to have resigned." (ICSID Arbitration Rules, rule 6.2).

Further Arbitration Rules have considered fairness in the resolution of disputes. For example, under Article 15.1 of the UNCITRAL Rules, "the arbitral tribunal may conduct the arbitration in such manner as it considers appropriate, provided that the parties are treated with equality and that at any stage of the proceedings each party is given a full opportunity of presenting his case." This article impliedly confers power on the arbitral tribunal to ensure fairness during the process of the resolution of dispute. Thus the rules acknowledge the necessity for application of procedural fairness.

It is worth noting that "even the fairest trial, conducted under conditions that closely approximate those of the ideal communication situation, can yield an unjust outcome if crucial information was not considered" (Solum 2004, 85). In addition "people may accept lesser outcomes from an organization if they experience its procedures to be fair. On the other

hand, they will be dissatisfied with an organization in which they experience their treatment by authorities to be rude and demeaning, even if they are not deprived of resources" (Tyler, 2001, p. 427). These complexities result in the ambiguity and defects of the concept of procedural justice precept.

The bottom line is that procedural justice as a subdivision of the rule of law is a necessary proviso for legitimacy of a dispute resolution system. In fact "the roots of legitimacy lie in people's assessments of the fairness of the decision-making procedures used by authorities and institutions" (Tyler, p. 416). The following chapter will explore the rule of law, legitimacy, and effectiveness in further detail.

CHAPTER 4: POWER & THE LAW

"Where-ever law ends, tyranny begins"

(Locke, *Second Treatise of Government* p. 103 (s. 202))

As explained in the previous chapters, with regard to the topic of this thesis, power is considered in a three dimensional relationship. Each of the three players of investment arbitration represents a type of power. In other words, although every player of an investment arbitration may possess different forms of power with different degrees, they are each a paradigm of a particular type of power. Thus in this study the state is an embodiment of political power, the power of the investor (MNE) is an epitome of economic power, and the power of the arbitrator is categorised as legal power. Different structural equation models can be generated on the basis of the hypothesized interactions between these powers:

i. Political power > economic & legal power
ii. Economic power > political & legal power
iii. Legal power > political & economic power

The underpinning nexus between these scenarios is explained on the basis of the relation between power and the law as two intertwined concepts. These equations are thus diverse compositions of domination of power and the law.

Two basic hypotheses are proposed in regard to the interaction of the powers of the state, investor and arbitrator and the applicability of the rule of law. The first hypothesis proposes that when legal power is defeated by the political and economic power of the parties; it follows that what the rule of law does not govern in investment arbitration and it is the dominant power – either political or economic power – that governs (equations i and ii); the so called *rule by law*. Rule by law is the use of the law as a tool of oppression (B. Tamanaha 2002, 27).

The second hypothesis is the superiority of the legal power of arbitrators over the political and economic power of the parties that leads to the application of the *rule of law* by arbitrators in investment arbitration (equation iii) – subject to substantive and procedural requirements, which will be discussed in the 'Rule of Law' part below.

One effect of the superiority of legal power – the rule of law – is to ***impede*** any exertion of power by investors or host states in the resolution of their conflicts. This function of the rule of law as the impediment of the exercise of power is the basic and fundamental prerequisite for the legitimacy of the arbitration. Conversely, the inferiority of legal power and superiority of economic and/or political power of the parties result in the rule by law and thus delegitimzation of the arbitration system.

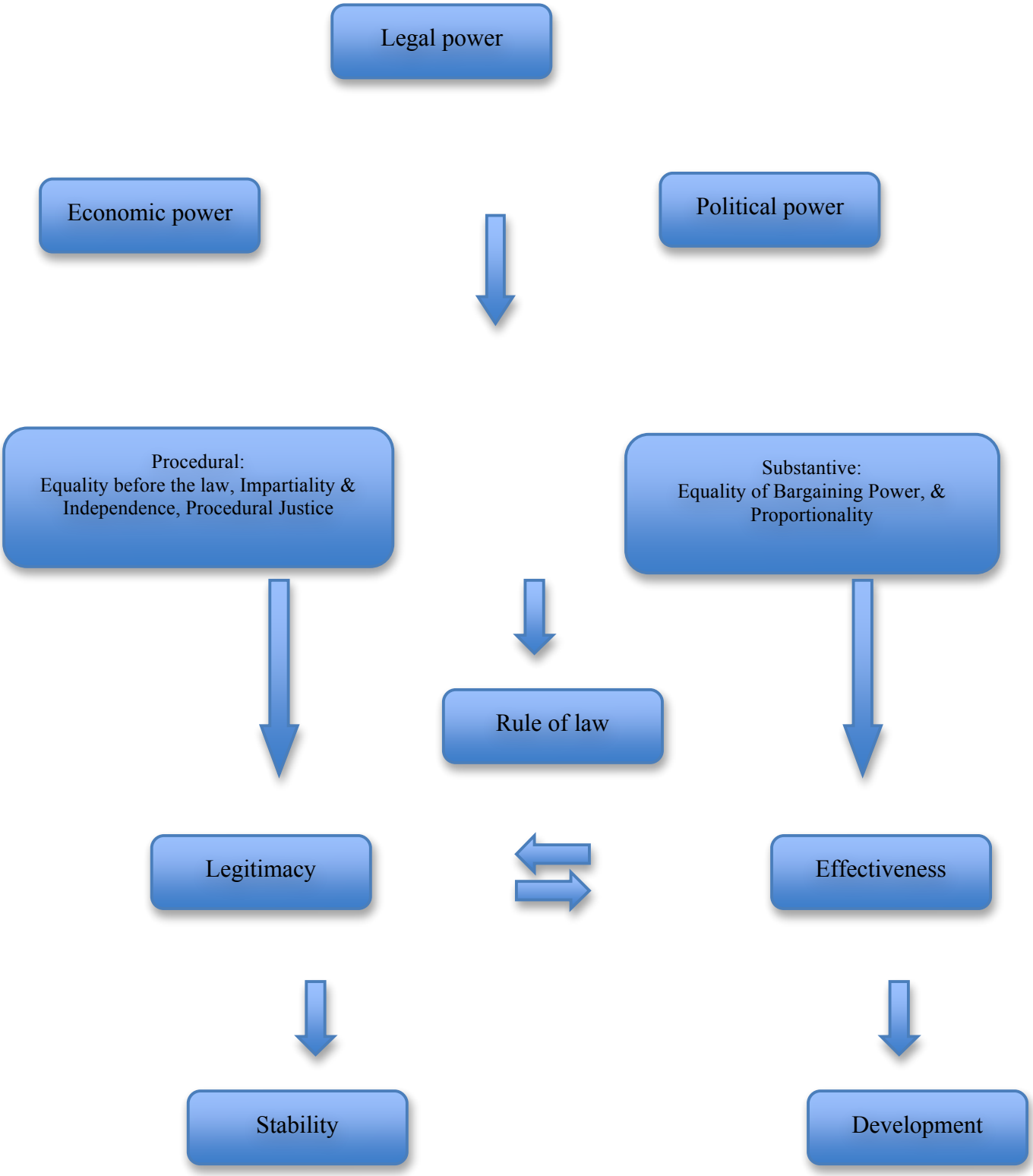
The other effect of the rule of law with regard to investment arbitration is to increase the effectiveness of the system through ***balancing*** power inequalities. Legitimacy and effectiveness are interlinked concepts; in the passage of time delegitimacy of investment arbitration system can lead to ineffectiveness of the system.

This chapter thus proceeds on the basis of the following hypothesis: the rule of law – supremacy of the legal power of arbitrators over the political and economic power of the parties – viewed both as a restraint on the misuse of power and as a tool for balancing powers, is the necessary condition for legitimacy and effectiveness of the investment arbitration system. Legitimacy can lead to effectiveness and vice versa and they can result in stability and development of the investment arbitration system respectively. Thus the principal obligation of arbitrators is to comply with the rule of law. The ability and expertise of arbitrators plays a major role in reconciling different elements of the rule of law and therefore rendering arbitration a legitimate and effective means. The proposed hypothesis is shown in the following conceptual map (See Figure 4).

The rule of law, legitimacy, and effectiveness as the building blocks of this hypothesis are analysed in this chapter in order to illustrate the underlying notions and their potential interaction. Thus, in the first part of the chapter, the rule of law and its theoretical notion are examined. Legitimacy as the by-product of the rule of law will be investigated in the second part. Here the definition of legitimacy, its indicators and effects are explained. The final part deals with the definition of effectiveness, its indicators and relation with legitimacy.[105]

[105] It is worth mentioning that the various theoretical precepts that are used as a framework for this subject are extensively analysed by legal and social theorists; the objective here is mainly to build the ideas in the context of foreign investment based on the previous theoretical works.

Figure 4: The Rule of Law, Legitimacy, and Effectiveness of Investment Arbitration



A. The Rule of Law

In the context of foreign investment, "The rule of law concept evolved as a framework for protecting individuals from the state, and foreign investors (and other foreign nationals) are of course vulnerable to state abuse" (Van Harten, 2010, p. 637). Nonetheless, the breadth of the rule of law is not confined to the protection of one party. The function of the rule of law is to govern the legal power to the conflicting parties' relationships.

This part examines the nature of the rule of law in the field of foreign investment; the theoretical analysis of this concept in general will be examined at the outset. The rule of law is one of the critical and controversial concepts of legal theory. The rule of law will be examined as an underpinning indispensable concept to pave the way for the ultimate objective, which is the analysis of law and power in investment arbitration. Therefore a brief introduction to the rule of law is provided in order to clarify its notion.

"The rule of law is the basic assumption of the medieval approach to the problem of power"(D'Entreves 1967, 82) and denotes that power is exercised in accordance with the law. The aim of the rule of law is to avoid arbitrary power and to protect rights. The rule of law can be regarded as a barrier upon arbitrary power (Chesterman 2008); it controls the misuse of power. In other words, the rule of law is an impediment to the exercise of power by the powerful party. The rule of law, thus, for the purpose of this study is conceptualised as the superiority of the legal power of arbitrators over the political and economic power of the conflicting parties.

However, this supremacy is subject to some precepts as the constituting elements of the concept of the rule of law. To put it differently, the legal power of arbitrators shall be supreme when some principles of the rule of law are present; the mere superiority of the power of arbitrator disregarding the preliminary principles is rule of man, or as it is also called rule by law.

So far as the relation between the law and power is concerned, a distinction can be made between rule by law and rule of law. Rule by law implies that power is channelled through law, under the mask of a legal form and is least observable. This form of exercise of power is decisive as "power is at its most effective when least observable" (Lukes, 2005, p. 1). Law in this case is an instrument of tyranny.

Regarding the rule of law, its roots can be traced back to the Ancient Greeks. Around 350 BC, Plato and Aristotle emphasised the importance of the rule of law in a society, stating that "Law should govern", and this is the principal perception of the concept of the rule of law:

> "it is more proper that law should govern than any one of the citizens: upon the same principle, if it is advantageous to place the supreme power in some particular persons, they should be appointed to be only guardians, and the servants of the laws, for the supreme power must be placed somewhere; but they say, that it is unjust that where all are equal one person should continually enjoy it" (Aristotle, 2007, p. Book III/16).

One of the central themes of Aristotle's theory of the rule of law is the preventive effect of the rule of law on the exercise of power. The relationship between power and the rule of law, thus, has been a ubiquitous issue.

In modern times the rule of law has been a pervasive and contested issue with considerable debates over its notion. One of the reasons is the ambiguity in the meaning of the word *law* (Fletcher 1996). There are two distinct meanings of law in English language: law as a set of enacted rules that are supposed to be good and just but may sometimes be unjust (depending on the degree of democracy of the government that promulgates the law); and Law with a capital L, equivalent to rights that are always just (Fletcher 1996). Depending on the meaning taken for 'law' the concept of the 'rule of law' varies. Accordingly, the rule of law in one sense means governance of the rules that are enacted, and in the other wider sense is the supremacy of justice. As Fletcher argues:

> "In English we are never quite sure what we mean by the "rule of law". Do we mean rule by the laws laid down – whether the legal rules are good or bad? Or do we mean "rule by law," by the right rules, by the rules that meet the tests of morality and justice? Because we have only one word for law in place of the two commonly found in other legal systems, we suffer and perhaps cultivate this ambiguity" (Fletcher 1996, 13).

In parallel to the classification of the rule of law on the basis of the notion of the term 'law', another categorisation is the orthodox division of *formalistic* and *substantive* approaches to the rule of law. Apart from the various meanings of law that affect the concept

of the rule of law, the differentiation between formal and substantive meanings of the rule of law is a substantial criterion in ascertaining the legal precepts that derive from the rule of law.

According to the substantive or thick approach of the rule of law, "the content of laws will be evaluated in order to determine whether they are compatible with the moral rights which individuals possess" (Craig 1997, 480). As in the international domain the law is not disciplined as a set of enacted rules like the rules in national law, and also as arbitration has a procedural rather than substantive orientation, therefore the substantive aspect of the rule of law, in the sense of the content of the law, is not examined as part of and is out of the context of this thesis.

Conversely, according to the formal or thin approach, "whatever the content of the law, at least it should be open, clear, stable, general and applied by an impartial judiciary." (Craig 1997, 470) Therefore, the formal approach focuses on the procedural aspects of a legal system and as this thesis is based on international arbitration procedure, thus the formal aspect of the rule of law will be the central focus.

The formalistic approach of the rule of law encompasses different principles, and different definitions emphasise these maxims. Some of the principal views of formal rule of law will now be examined in order to show the diverse and expansive scope of this aspect and to extract the most prevalent principles of the rule of law from these definitions.

Dicey, one of the prominent scholars in this field, defines the rule of law by emphasising three elements. According to the first principle,

> "no man is punishable or can be lawfully made to suffer in body or goods except for a distinct breach of law established in the ordinary legal manner before the ordinary Courts of the land. In this sense the rule of law is contrasted with every system of government based on the exercise by persons in authority of wide, arbitrary, or discretionary powers of constraint." (Dicey 1902, 110)

Secondly, Dicey identifies the equality requirement of the rule of law; that everyone is equal before the law regardless of his or her power. Lastly, he specifies the importance of judicial decisions in evolving the rule of law through individual cases(Dicey 1902). In Dicey's classification, the second principle is pertinent to the present subject.

Raz, another theorist of the formal approach, identifies the main characteristics of the rule of law by some principles: (1) All laws should be prospective, open, and clear (2) Laws should be relatively stable (3) The making of particular laws (particulate legal orders) should be guided by open, stable, clear, and general rules (4) The independence of judiciary must be guaranteed (5) The principle of natural justice must be observed (6) The courts should have review powers over the implementation of the other principles (7) The courts should be easily accessible (8) The discretion of the crime-preventing agencies should not be allowed to pervert the law" (Raz, 2009).

According to this definition, the rule of law is composed of several principles, though the principle of independence and the principle of natural justice shall be used as the preconditions of arbitrators' legal powers.

Besides the scholarly definitions of the rule of law, the concept of the rule of law has been the centre of attention in the international level. Accordingly, international organisations have touched on the issue of the rule of law and provide definitions of that with regard to their goals and objectives. One of the comprehensive definitions is the UN conceptualisation of the rule of law:

> "a principle of governance in which all persons, institutions and entities, public and private, including the State itself, are accountable to laws that are publicly promulgated, equally enforced and independently adjudicated, and which are consistent with international human rights norms and standards. It requires, as well, measures to ensure adherence to the principles of supremacy of law, equality before the law, accountability to the law, fairness in the application of the law, separation of powers, participation in decision-making, legal certainty, avoidance of arbitrariness and procedural and legal transparency" (The United Nations General Assembly n.d.).

The International Bar Association's (IBA) concept of the rule of law elaborates the main principles of the rule of law as follows:

> "An independent, impartial judiciary; the presumption of innocence; the right to a fair and public trial without undue delay; a rational and proportionate approach to punishment; a strong and independent legal profession; strict protection of confidential communications between lawyer and client; equality of all before the law; these are all fundamental principles of the Rule of Law. Accordingly, arbitrary arrests; secret trials;

indefinite detention without trial; cruel or degrading treatment or punishment; intimidation or corruption in the electoral process, are all unacceptable. The Rule of Law is the foundation of a civilised society. It establishes a transparent process accessible and equal to all. It ensures adherence to principles that both liberate and protect. The IBA calls upon all countries to respect these fundamental principles. It also calls upon its members to speak out in support of the Rule of Law within their respective communities" (Resolution of the Council of the International Bar Association of October 8, 2009, on the Commentary on Rule of Law Resolution 2005).

The OECD similarly elucidates the concept of the rule of law by its main principles:

"[T]he rule of law is composed of the following separate fundamental elements, which must advance together: 1. The existence of basic rules and values that a people share and by which they agree to be bound (constitutionalism). This can apply as much to an unwritten as to a written constitution. 2. The law must govern the government. 3. An independent and impartial judiciary interprets the law. 4. Those who administer the law act consistently, without unfair discrimination. 5. The law is transparent and accessible to all, especially the vulnerable in most need of its protection. 6. Application of the law is efficient and timely. 7. The law protects rights, especially human rights. 8. The law can be changed by an established process that is itself transparent, accountable and democratic" (OECD 2005).

Synthesising the various definitions and approaches, it can be perceived that some principles are shared in the aforementioned conceptions of the rule of law. The main principles that are addressed by these main standpoints and that are pertinent to the theme of investor-state arbitration can be summarised as follows: (1) Equality before the Law, (2) Independence and impartiality of the judiciary, (3) Fairness in the application of the law, non-discrimination and avoidance of arbitrariness.

A legal system in order to be in compliance with the rule of law must therefore have certain attributes – which are considered as the elements of the rule of law. Equality before the law, fairness in the application of the law (procedural justice), impartiality and independency are the necessary attributes for the arbitration system in order to be in accordance with the rule of law.

The definitions of the rule of law emphasise the procedural aspect of the role of arbitrators as examined in Chapter 3, part C. It was argued that in exercising their powers, arbitrators should abide by the procedural principles of the rule of law. Equality before the law, impartiality and independence, and procedural justice, thus, confer legitimacy on international investment arbitration and it is in this case that arbitrators' powers can legitimately govern and be superior to those of the conflicting parties.

However, as discussed in part B of the preceding chapter, arbitrators have a role in respect to the substantive aspect of the exercise of power of the parties at different stages, including the bargaining and performance phases. Recall that with regard to the former – bargaining – the doctrine of inequality of bargaining power can be used by arbitrators to redress the power inequalities and with regard to the latter – performance – the principle of proportionality can balance the relationship between investors and host states. Balancing the powers of the parties in the bargaining and the performance phases can enhance the effectiveness of the international investment system.

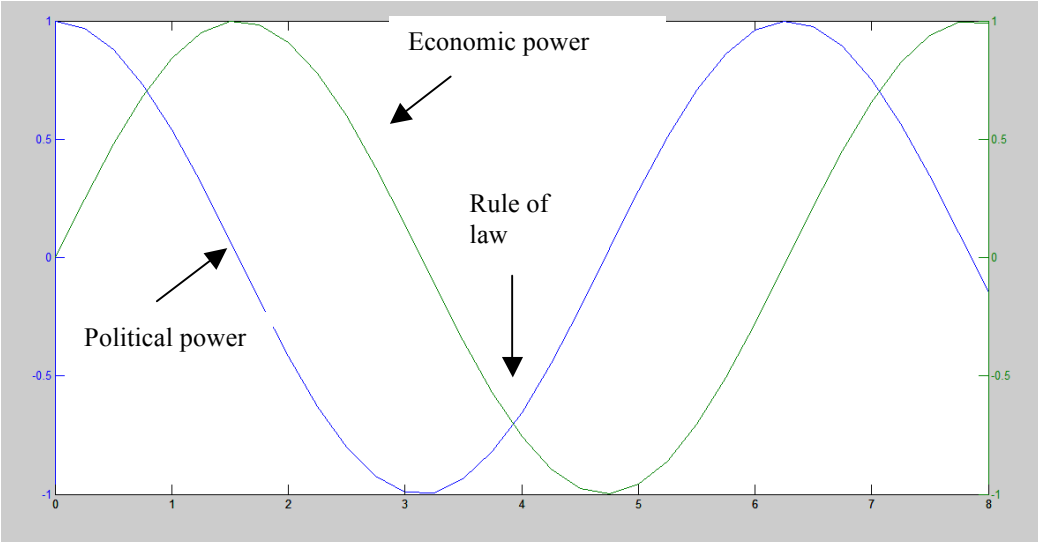
Thus, the rule of law for the purpose of this thesis can be defined as *the supremacy of the legal power of arbitrators, as long as they comply with the principles of equality before the law, impartiality and independence, and procedural justice, and also the principles of inequality of bargaining power and proportionality*.

To put this another way, the power of arbitrators in balancing the powers of the parties in respect to the bargaining and the performance of investment, along with their role with regard to the powers of the parties in the process of conflict resolution, constitute the rule of law. The rule of law confers on the arbitrators the authority to govern the relationship of the parties by their legal powers.

Hence, the most important underlying issue of the rule of law is the governance and supremacy of the law. The foundation of the definition of the rule of law in this study highlights the governance of the law through the supremacy of the legal power of arbitrators in resolving conflicts. It is in this case that the supremacy of the legal power of arbitrators over the political and economic powers of the states and investors in the conflict resolution process is permitted.

Figure 5 shows the effect of the rule of law on the powers of the parties. The supremacy of the legal power of arbitrators impedes any misuse of power and then balances the power imbalances between the parties; in other words, the effect of the rule of law is to confer legitimacy on the investment arbitration system by impeding any misuse of power, and to enhance its effectiveness by balancing power inequalities.

Figure 5: The Role of the Rule of Law on Power



B. Legitimacy

There are arguments and concerns regarding the issue of legitimacy of investment arbitration. The first claim of 'legitimacy crisis' in investment arbitration is in relation to the indicators of legitimacy (Ortino, 2009) (Brower and Schill 2008-2009) (Franck S. D., 2005). The main problematic issues in this respect are incoherence, indeterminacy, and the lack of transparency in investment arbitration. A lack of the indicators of legitimacy does not immediately delegitimize investment arbitration, however in the passage of time the decrease of indicators can result in illegitimacy.

Another objection to the legitimacy of investment arbitration, as it is argued in this study, is in relation to the institution of investment arbitration as a whole system. This claim is linked to the issue of power and the rule of law – as the supremacy of the legal power – and argues that "investment treaties and investment-treaty arbitration institutionalize a pro-investor bias that casts the legitimacy of the entire system of international investment law and arbitration into doubt" (Brower and Schill 2008-2009, 475). This claim in effect concerns the source of legitimacy and affects the existence of legitimacy. It is the latter claim that constitutes the core of the legitimacy debate in this study, and will duly be examined. Accordingly the principal argument is "a hegemonic critique of international investment law that originates from a Marxist analysis of international law and views international investment law as an attempt by developed countries to impose their power on weaker, developing countries" (Brower and Schill 2008-2009, 474). This critique is based on an analysis of power and therefore pertinent to the theme of this thesis. In other words, whether

in investment the power of arbitrators is used arbitrarily, affects the *legitimisation* and *maintenance* of legitimacy of the investment arbitration institution.[106]

This second part of the chapter is based on the hypothesis that *legitimization* occurs through the principle of the 'rule of law'. The *maintenance of legitimacy*, which leads to stability, is achieved by preserving the indicators and characteristics of legitimacy; by contrast *delegitimization* of an institution, rule or a position of authority occurs by the 'rule by law', i.e. the inferiority of legal power and domination of the power of the conflicting parties. Therefore the sustainability of investment arbitration depends on establishing legitimacy (by the rule of law principle) as well as maintaining it (by the indicators of legitimacy). Without legitimacy the institution loses its validity. Delegitimization transforms authority to an unauthorised power; in other words when arbitrators – as authority holders – lose their legitimacy, they no longer possess the authority to make decisions between the conflicting parties. Table 4 shows graphically the process of legitimization to delegitimization and the role of the law (supremacy of legal power) in this process.

[106] In this respect it has been stated that the maintenance of legitimacy "depends primarily on the perception that certain mechanisms for legitimate rule exist, that they are intact, and that they are being used as necessary. Mechanisms of legitimate rule, in essence, refer to procedures and criteria for preventing the arbitrary use of power" Kelman, H. C. (2001). Reflections on Social and Psychological Processes of Legitimization and Delegitimization. In J. T. Jost, & B. Major (Eds.), *The Psychology of Legitimacy: Emerging Perspectives on Ideology, Justice, and Intergroup Relations.* Cambridge, UK: Cambridge University Press, p. 71.

Table 4: The Process of Legitimization to Delegitimization

Legitimization	Maintenance of legitimacy	Delegitimization
• **Rule of Law** • *impartiality* • *equality before law* • *procedural justice* • *balancing inequality of bargaining power* • *balancing the interests*	• **Indicators of legitimacy** • *determinacy* • *coherence* • *validity* • *adherence*	• **Rule by Law** • *bias* • *inequality* • *unfairness*

In order to be able to understand the legitimacy of arbitration, it is necessary to investigate its conceptual origins and theories that explore this concept. By understanding the notion of legitimacy in general, its position can be determined with comparative ease in more specific fields such as investment arbitration. The concept of legitimacy is examined in chapter 1. Indicators of legitimacy, and the effects of legitimacy will be examined here. These issues together constitute the foundational structure of the debate on legitimacy, which can lead the discussion to the required subject: the relation between power and the law in investment arbitration.

I. Indicators of Legitimacy

Legitimacy is an abstract concept; it is a belief and therefore is a subjective issue. However some observable indicators objectify it. In other words, the representative indicators facilitate the measurement of legitimacy. Indicators of legitimacy are *determinacy, symbolic validation, coherence,* and *adherence* (Franck T. M., 1990). Before illustrating the notion of the indicators of legitimacy, it is worth emphasising that legitimacy, like many other social

concepts, is a matter of degree; these observable factors increase and decrease the degree of legitimacy, but they do not bring legitimacy to existence (Franck T. M., 1990). In other words, the indicators are not the means of legitimization. The rule of law, as discussed, is one of the main sources of legitimacy, whereas indicators are characteristics of a legitimate institution. A decrease of these indicators, leads to undermining legitimacy and may in the passage of time and indirectly result in illegitimacy. Determinacy and coherence are two indicators that are widely addressed in investment arbitration – and will therefore now be addressed.

Determinacy related to the transparency and clarity of the rules. Generally the rules defining the obligations and rights of the contracting parties – the investor and the host state – must be clear. However some rules are deliberately drafted vaguely in order to promote fairness in accordance with the circumstances of the case (Franck S. D., 2005).

Coherence denotes that a system of rules or an authority "treats like cases alike" (Franck T. M., 1995, p. 38). Incoherence in investment results in inconsistencies in the outcome of the cases and the arbitral tribunals' awards. The inconsistent Argentine investment cases before the ICSID tribunals are the best exemplar of inconsistency in investment arbitration.[107]

Interpretation is one of the mechanisms for increasing the determinacy of vague and general rules. "[W]ho is doing the interpreting, their *pedigree* or authority to interpret, and the *coherence* of the principles the interpreters apply" are essential issues that must be considered in interpreting rules (Franck T. M., 1990, p. 61). Interpretation is itself subjective

[107] For instance the decisions of *LG&E Energy Corp, LG&E Capital Corp, LG&E International Inc v Argentine Republic* (ICSID Case No ARB/02/1), Decision on Liability of 3 October 2006, and *CMS* and *Sempra v Argentina* (ICSID Case No ARB/01/8), Annulment Proceeding, September 25, 2007, are incoherent in respect to the scope of umbrella clauses.

and discretionary. Therefore it is claimed that the indeterminacy of investment rules widens the discretionary power of arbitrators and this can lead to unpredictability in foreign investment. Indeterminacy concerns vagueness of investors' rights – the protection standards in treaties. For instance fair and equitable treatment, as common rights of the investors in virtually all BITs, is a broad concept that has led to extensively inconsistent interpretations and judgements.

A critical issue in this regard is the fact that indeterminacy does not directly lead to illegitimacy; it affects the degree of legitimacy. The more determinate and transparent the rules, the higher the degree of legitimacy. In the context of investment arbitration, arbitrators have the power to interpret and rectify the indeterminacy, and therefore increase the legitimacy of investment arbitration.

II. Effects of Legitimacy

Compatibility with the principles of the rule of law gives the institution of arbitration legitimacy, and legitimacy confers credibility and validity. Credibility, like reputation, is a type of social power. When arbitration is validated through endorsement of the conflicting parties, it has in fact gained credibility and power by its main consumers.

Validity "refers to an individual belief that he or she is obliged to obey these norms even in the absence of personal approval of them" (Johnson 2004, 3). Validity, as a collective support, may be embodied in two forms: authorization and endorsement. The former is a support by the peers of the authority holder or its superior authorities; endorsement on the other hand is a support by the peers of the subject of the authority or other subordinates (Zelditch, 2001). In the context of investment, the support of the investors and host states as conflicting parties and subordinates of arbitrators confers validity on the investment arbitration institution through endorsement. Endorsement by the conflicting parties is through

compliance with and obedience to the decisions of arbitrators. The more they obey and voluntarily enforce the arbitral awards, the more the validity of arbitration may increase. In the words of Frank, "the degree to which a rule is obeyed affects the *degree* to which it is cognizable as a valid obligation. Reciprocally, the extent to which a rule is cognizable as a legitimate obligation affects the extent to which it is obeyed" (Franck T. M., 1990, p. 44).

Therefore the claim by those groups that consider arbitration a pro-investor mechanism and believe that it "should be replaced by a genuinely justice-oriented system of dispute resolution for it to have any credibility" (Sornarajah, 1997, p. 107) suggests that arbitration – the institution as a whole – should gain social power by being endorsed and validated by both investors and host states. Thus legitimacy of arbitration can confer validity, credibility and power on the institution.

As for authorisation, which is validation by peers or those who are at the same level as the power holders, it can be argued that commercial – non-investment – arbitrators, other institutions of conflict resolution such as courts, mediators, academic, NGOs, and lawyers have a crucial impact with regard to validation of the investment arbitration system and enhancing its legitimacy.

Furthermore the purpose and effect of legitimacy is to provide *stability*. Legitimacy "is a kind of auxiliary process that explains the stability of *any* sort of structure, at any level, that emerges and is maintained by *any* other basic social process" (Zelditch, 2001, p. 40). Legitimacy is one of the fundamental theoretical issues that preserves the stability of an institution of authority; "in organizational research, issues of legitimacy processes have been, and continue to be, of central concern for predicting organizational growth and survival" (Johnson 2004, 1). In this respect "it has been argued that social systems which have the general support or endorsement of their members are more stable (cf. Parsons), that norms or

rules which are endorsed are less likely to be publicly violated (French and Raven; Weber), and that leaders who are endorsed are more likely to secure compliance to their demands (Dornbusch and Scott; Etzioni; French and Raven; Hollander; Homans)" (Walker, Thomas, & Zelditch, 1986, p. 622). Thus legitimacy results in sustainability and survival of the investment arbitration institution. Whether legitimacy leads to effectiveness of the system will be examined in the following part.

C. Effectiveness

The previous part concluded that the rule of law is a prerequisite for legitimacy and that legitimacy is the first stage and a preliminary requirement for sustainability of the investment arbitration system. In this part I will now draw upon the second stage of the requirements of investment arbitration, which is not just the maintenance and sustainability, but the development of the system. Effectiveness of investment arbitration puts into perspective the growth and development of the system. It is essential to enhance or at least preserve the effectiveness of investment arbitration, "Otherwise, the "restless consumers", or users, of arbitration might "travel on" to more efficient means of settling their investment disputes" (Markert 2011, 242).

Before venturing into an analysis of the term 'effectiveness' and its relevance to investment arbitration, it is worth noting that arbitration – as a binding conflict resolution mechanism – is more effective in terms of power balancing, in comparison to non-intervention mechanisms such as negotiation or even non-binding mechanisms with third party intervention such as mediation. The two latter forms are based on bargaining and negotiating powers of the parties with the control and management of the third party. Arbitration – and litigation – on the other hand owes its legitimacy to the application of the rule of law rather than power. Arbitrators can have a controlling role over the abuse of power by the powerful party and they can balance the inequalities. In other words, there is an inverse relationship between the power of the conflicting parties and the choice of binding conflict management; "a standard deviation increase from the mean value of power asymmetry decreases the probability of binding conflict management" (Gent & Shannon, 2011, p. 726). Parties with a power advantage prefer to settle their disputes by negotiation in order to influence and impose their preferred solution on the weaker party. The following

passage, although in regarding to the disputes between states, underpins the overall effectiveness of arbitration in comparison to other methods of conflict resolution:

> "when a state enjoys a strong power advantage over a fellow disputant, it prefers to settle its disputes through means other than binding conflict management. Weaker states benefit from arbitration and adjudication because these forums place them on a more level playing field with more powerful states." (Gent & Shannon, 2011, p. 719).

Notwithstanding, the question that this thesis seeks to explore is not a comparative analysis of the effectiveness of conflict resolution mechanisms; it is an evaluation of arbitration's effectiveness on its own. Effectiveness is a central concern that arises in regard to any institution, particularly those that are in their early stage and those that are common and widely used. The purpose of effectiveness is to test the function of a system and to examine whether the system is useful and in line with its objectives and *raison d'être.*

Investment arbitration, as a relatively new system as well as the most common means of conflict resolution in the field of investment, is thus the subject of effectiveness.[108] The issue of effectiveness of investment arbitration has been explored from different standpoints.[109] This thesis will try to approach the question of effectiveness from a specific

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[108] This is a relatively new concern of practitioners and scholars. For instance, "Is arbitration the truly effective vehicle for resolution of foreign investment disputes that it is often assumed to be?" (Rosendahl, 2004)

[109] Some – if not most – of the literatures in the field of investment arbitration address this question from the point of view of the practitioners of this field: arbitrators and advocates. Therefore they believe that arbitration is an effective mechanism for resolution of investment disputes (Horn & Kroll, 2004). A few scholars hold the opposite view; they believe that in order to examine the effectiveness of investment arbitration the views of the consumers of this mechanism – the disputing parties – are the more reliable because they are "the observer and evaluator of the current state of the system" (Rosendahl, 2004, p. 34). Thus they argue that "where the stakes are high, host government entities are involved (e.g. infrastructure projects) and the rule of law itself is in its infancy, arbitration alone, without more, has often proven to be unreliable as an effective mechanism for dispute

perspective: the role of power of arbitrators in enhancing the effectiveness of the international investment arbitration system and investment system as a whole.

For analysing the effectiveness of investment arbitration, it is advisable to delineate its notion at the outset. The general concept of effectiveness prepares the way for illustration of its usage in the field of investment arbitration. Thus, the first section below will briefly examine the concept of effectiveness. Effectiveness is abstract and must be measured by some indicators representing its degree. These indicators will be identified in the second section. Then by virtue of the definition and indicators of effectiveness, the third section will investigate and analyse the correlation between effectiveness and legitimacy in the field of foreign investment arbitration.

I. Definition of Effectiveness

Effectiveness[110] is multifaceted and it can be examined from different dimensions. A system may be effective from one standpoint and not effective from another. Furthermore effectiveness is a matter of degree; a system may be to some extent effective but not absolutely effective. Therefore the term 'effectiveness' is a complex concept that can be used in a bewildering variety of ways.

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resolution" (Rosendahl, 2004, p. 34). Pragmatically, the consumers' view ought to be the criterion for assessing the effectiveness of the investment arbitration system and can more plausibly reflect the real situation.

[110] It is important to compare the concept of effectiveness with similar terminologies. Efficiency is an analogous term that is often used synonymously with effectiveness. Efficiency is "the ability to do things right rather than the ability to get the right things done" (Drucker, 2007, p. 2) An efficient arbitration, thus, is 'to do things right'; it is to arbitrate and resolve disputes in a right manner. Cost and time are two indicators of efficient arbitration. If arbitration is done in time and with low cost it is considered efficient. Myriad studies (mainly under the title of advantages of arbitration) have investigated the efficiency of arbitration based on time and cost. These two factors are not pertinent to the present subject.

There are myriad purposes for studying the effectiveness of a system. One may be to assess the way a system functions to ascertain the compatibility of its functioning with its initial objectives. For instance the aim of the study of effectiveness in this thesis is to assess the function of the investment arbitration system in respect to balancing the power of the parties. Further purposes of evaluating the effectiveness of a system may be to determine the reason behind the state of the system, the actions that must be taken to improve the *status quo*, to compare the functioning of a system with other systems, and to rank the effectiveness of the system (Campbell 1981).

All these purposes of the measurement of effectiveness indicate that effectiveness is interconnected with the concept of management and execution. Accordingly, the concept of effectiveness is extensively discussed in management literature. Arbitration is a type of management – management of the disputes between two parties – and arbitrators are executives of this process. Thus in order to define effectiveness of the functions of investment arbitration it is of benefit to borrow the conceptual analysis of effectiveness from management and apply necessary adjustments to adapt it to the theme of foreign investment arbitration.

Generally, effectiveness is defined as "get the right things done" (Drucker 2007, 1). It is concerned with doing the right things depending on the circumstances and objectives. An effective arbitration is to do the right thing in resolving disputes. The right thing is determined by the objective and circumstances of each case.

Lipset, an eminent political sociologist, argued that "By effectiveness is meant the actual performance of a political system, the extent to which it satisfies the basic functions of government as defined by the expectations of most members of a society, and the expectations of powerful groups within it which might threaten the system, such as the armed

forces" (Lipset 1959, 86). This definition in fact corresponds with the function assessment purpose of the concept of effectiveness.

The essential concern here is to ascertain the function of investment arbitration. Generally, the function of arbitration – mainly commercial arbitration – is compared to the function of the courts. While the primary function of both mechanisms is to resolve disputes, they significantly diverge in regard to the secondary functions. Courts have the duty to preserve the public interests while resolving disputes(Lew, Mistelis and Kroll 2003); therefore they have a private as well as public function. Conversely, international commercial arbitration as a private means of dispute resolution has foremost the obligation to ensure the resolution of private interests of the disputing parties; "The arbitrator's central obligation is to resolve the parties' dispute in an adjudicatory manner"(Born 2009, 1616). Although this comparison between courts and arbitration can be correct in general, it cannot be entirely applicable to investment arbitration. The characteristic nature of the parties in investment conflicts, particularly the presence of states and public interests of the host nation, prevents the generalisation of commercial arbitration's functions to investment arbitration. On the other hand, it can be argued that the function of investment arbitration is close to the function of the courts. The optimum function of investment arbitration is to resolve conflicts as well as considering the public interests of the host states. In fact, in investment conflicts the public interests of the host states are often the subject of the conflict and are considered as the primary function of arbitrators rather than a secondary function. Thus, it can be concluded that the function of investment arbitration is to resolve disputes by taking into consideration the public interests and balancing them with private interests.

Accordingly, the effectiveness of investment arbitration can be defined as *the actual performance of the investment arbitration system or the extent to which the investment*

arbitration system satisfies the basic functions of resolving conflicts by considering public and private interests and balancing them. By this analysis it can be concluded that investment arbitration is not effective if arbitrators fail to consider the public interests of host states and balance them with the private interests of investors. This conclusion implies that balancing of power inequalities is an optimisation mechanism for the effectiveness of the international investment arbitration system and its development.

II. Indicators of Effectiveness

The measurement of effectiveness is highly complex. One of the reasons seems to lie in the fact that effectiveness is a qualitative and abstract concept. The theme of the thesis is power, and assessing effectiveness from this aspect is even more cumbersome, as power itself is highly obscure and imperfect in terms of definition as well as measurement. Therefore some objective indicators will now be explored in order to measure effectiveness.

Generally there are two approaches to the measures of effectiveness: goal-centred view and the natural systems view (Campbell 1981). Campbell has provided a non-exhaustive list of criteria to measure organisational effectiveness (Campbell 1981).

> "1. Overall effectiveness, 2 Productivity, 3 Efficiency, 4 Profit, 5 Quality, 6 Accidents, 7 Growth, 8 Absenteeism, 9 Turnover, 10 job satisfaction, 11 Motivation, 12 Morale, 13 Control, 14 Conflict/Cohesion, 15 Flexibility/Adaptation, 16 Planning and Goal Settings, 17 Goal Consensus, 18 Internationalization of Organizational Goals, 19 Role and Norm Congruence, 20 Managerial Interpersonal Skills, 21 Managerial Task Skills, 22 information Management and Communication, 23 Readiness, 24 Utilization of Environment, 25 Evaluations by External Entities, 26 Stability, 27 Value of Human

Resources, 28 Participation and Shared Influence, 29 Training and Development Emphasis, 30 Achievement Emphasis"(Campbell 1981).

Although these measures are mainly related to the field of organisational management, some are of general nature and can be extended to the present topic. A further classification entails the essential factors of the above-mentioned list and is more pertinent to the effectiveness of international investment arbitration tribunals.

Compliance, usage and success have been determined as three main indicators in measuring the effectiveness of supranational tribunals in general (Posner and Yoo 2005) (Helfer and Slaughter 1997). These indicators will be examined in order to ascertain whether they can serve the purpose of measuring effectiveness of investment arbitration from the power balancing perspective.

In their expansive research on the effectiveness of supranational adjudication, Helfer and Slaughter "measure the effectiveness of a supranational tribunal in terms of its ability to compel compliance with its judgements" (Helfer and Slaughter 1997, 290). For them, the criterion in assessing effectiveness of a supranational tribunal is the pull of compliance in enforcing the awards issued by these tribunals. In other words, the more the tribunals' judgements are complied with, the more effective they are. Compliance can be measured quantitatively by the total sum of enforced judgements and therefore it facilitates the measurement of effectiveness(Helfer and Slaughter 1997).

Compliance to enforce a judgement can be through different means and causes. One cause of compliance may be effectiveness; in this sense compliance can be regarded as an indicator representing the effectiveness of arbitration. It denotes that arbitration is effective in

redressing power imbalances and consequently the disputing parties are satisfied with the outcome and comply with it. Nonetheless, compliance is not merely for the reason of effectiveness.

Other causes such as legitimacy of arbitration may result in compliance. Recall from our discussion on legitimacy that Thomas Frank defines legitimacy as the 'pull of compliance.' Based on his conceptualisation of legitimacy, the more the judgements of tribunals are complied with, the more legitimate that tribunal is; thus compliance can be considered as a measure of legitimacy rather than effectiveness. Legitimacy and effectiveness are entwined and one can lead to the other. However, legitimacy does not necessarily engender effectiveness. In other words, the compliance of the disputing parties may be as a result of the legitimacy of arbitration, though investment arbitration may still not be effective in redressing power imbalance. Therefore compliance is not an accurate indicator and does not precisely represent the effectiveness of an institution such as arbitration.

Furthermore, effectiveness can be measured on the basis of the usage of a dispute resolution system (Posner and Yoo 2005). The level of the usage of a dispute settlement mechanism by the disputing parties can be an indicator of its effectiveness. Based on the usage indicator one can conclude that regarding its increasing rate, investment arbitration is an effective dispute resolution mechanism in the field of international investment disputes. The usage measure, too, has problems. There might be several reasons for the increase in usage of arbitration. One reason for the usage of arbitration may be the deficiency of other mechanisms of dispute resolution in this field. By way of illustration, the bias of national courts litigation, as well as the non-binding nature of mediation (as two common methods used in parallel to arbitration) increase the usage of arbitration. Thus usage may not be a precise indicator of effectiveness.

Success has been suggested, as another indicator for measuring the effectiveness of arbitration (Posner and Yoo 2005). Accepting this criterion results in concluding that the growth and success of foreign investment is caused by effectiveness of arbitration. Although this claim may be correct to some extent, it is unsophisticated to consider that arbitration, a means of investment dispute resolution, is the only reason for the success of the foreign investment system. Furthermore, the success indicator can be rejected as the notion of success can be assumed to be part of the usage measure. In other words, the more that disputing parties use investment arbitration the more it can indicate that it is a successful mechanism.

It can be claimed that of the aforementioned indicators, the usage measure is the most appropriate indicator of effectiveness of investment arbitration and therefore effective investment arbitration, in a general sense, may be defined in terms of the growth of the usage of investment arbitration.

The objective of analysing the effectiveness of investment arbitration in this thesis is from a power dynamic perspective. As power is omnipresent in every interaction, it can be a factor for assessing effectiveness. However, it may better serve stereotyped relationships containing power imbalance such as employee-employer, tenant-landlord, and consumer-merchant relationships. Investment relationships have not been classified in the same category as the aforementioned stereotyped relationships of power inequality; nonetheless they are confrontations between two oligarchs: host states with political power, and investors (MNEs) with economic leverage. Therefore power can potentially be a relevant variable for assessing the effectiveness of arbitration in resolving investment conflicts.

Thus *the right thing* in regard to disputes between unequal parties is to resolve them by balancing the inequalities. An effective arbitration – at least from one perspective – is

resolving disputes by redressing power imbalances. Effectiveness in respect to the present subject can be defined as *the ability of arbitrators to resolve disputes between host states and investors while establishing a balance of power and interests, and restoring the equilibrium between the parties.*

III. Legitimacy and Effectiveness

Legitimacy and effectiveness are interrelated. Weber believed that legitimacy increases effectiveness. At a minimum, legitimacy is required as a prerequisite to the credibility of the arbitration institution. However the increase of legitimacy may lead to the increase of effectiveness of a system. In other words, the greater the legitimacy of an institution the more is the application and reference to that institution and therefore the more it may be effective or at least it may endeavour to be effective. On the other hand, ineffectiveness may in the long term lead to delegitimization of a system (Kelman 2001); "The ability to secure compliance increases the efficiency, effectiveness, and viability of the group" (Tyler, 2003, p. 285).

Investment arbitration is still legitimate when it does not consider the inequalities, but not effective. It is worth mentioning that the lack of effectiveness, in the passage of time, can affect legitimacy of investment arbitration. If arbitrators fail to resolve disputes effectively, the parties' confidence in this institution will diminish; eventually it may result in delegitimisation of investment arbitration. The matrix provided by Lipset best describes the correlation between effectiveness and legitimacy (See Table 5).

Table 5: The Correlation between Legitimacy and Effectiveness

Legitimacy	Effectiveness +	Effectiveness –
+	A	B
–	C	D

Those systems that fall under the scope of box A are effective and legitimate, and consequently they are stable. Conversely those systems that are in box D are neither legitimate nor effective and break down due to their instability. The systems that are in box A (are effective and legitimate) after facing an effectiveness crisis move to box B; they become ineffective but legitimate. Those systems that are in box C (effective but not legitimate) after encountering a legitimacy crisis move to box D and may break down. Thus it can be concluded that "a highly effective but illegitimate system, such as a well governed colony, is more unstable than regimes which are relatively low in effectiveness and high in legitimacy" (Lipset 1959, 91).

Applying the legitimacy/effectiveness correlation matrix to the investment arbitration system, it can be concluded that for a stable investment arbitration system, it shall be compatible with box A and therefore shall be both legitimate and effective. An investment arbitration system that is not based on the principles of equality before the law, impartiality and independence, and procedural justice, is illegitimate and can lead to the breakdown of the whole system. An investment arbitration system that is legitimate though does not consider the power imbalance and the conflict of interests between the investors and host states is ineffective and in the passage of time can lose its legitimacy and break down. Eventually an investment arbitration that is at the same time illegitimate and ineffective falls under the scope of box D and can collapse due to its deficiencies and be replaced by other more effective and legitimate means of dispute resolution.

Notwithstanding, it is worth noting that legitimacy and effectiveness are both matters of degree. Effectiveness is a spectrum that can be classified in terms of its position on a scale between two extreme points. The more effective the investment arbitration, the higher is its degree of legitimacy and therefore the greater is its validity amongst other means of dispute resolution. Therefore it is vital for the institution of arbitration to increase its effectiveness to

the optimum level. Effectiveness "is a habit; that is, a complex of practices. And practices can always be learned" (Drucker 2007, 22). Thus arbitrators, as executives of dispute resolution, can optimise the effectiveness of investment arbitration through techniques that can be learnt. This study considered the balancing techniques as a means of optimizing the effectiveness of investment arbitration.

CONCLUSION

AIM. The aim of this thesis was to underline the role and effect of power in the process of investment arbitration and investment system as a whole. The attempt was to approach the current challenges of the system, including legitimacy and effectiveness, from a power dynamic perspective and, thus, it has been claimed that power is an underlying factor that impacts legitimacy and effectiveness. Therefore the objective was to employ the concept of power to explore and understand the challenges presented by international investment arbitration. For this purpose this study was designed to introduce a theoretical framework, to examine power in the pre-arbitration and arbitration phases, and to explore the interconnection between law and power. A summary of the content will illustrate how this study has reached its aims and findings.

SUMMARY. The thesis starts with a theoretical exploration of the framework applicable to the study. The exchange theory is used as the theoretical framework that relates the principal ideas and concepts of the thesis. Power, conflict, justice, legitimacy, rationality, actors (the state, investors, arbitrators) are the core concepts of the thesis discussed under the exchange theory.

The central objective of the thesis has been to explore the interaction of the powers of the players in investment arbitration. The first phase is when the investment parties negotiate for an investment through formation of a contract or a BIT. In the negotiation or the bargaining phase the investment parties exercise their political and economic power in order to define the scope of their agreement. The agreement consists of the rights and duties of the parties and thus it can be concluded that the parties bargain for those rights. In one sense – Hohfeld's conception of rights – rights are defined in terms of power, and more particularly in this study, rights are conceptualised as legal power. In the bargaining phase the power of

the parties – the bargaining power – might not be equal and the powerful party might misuse its power in order to attain more advantageous legal powers.

After an investment agreement has been formed and the operation of investment begun, there is the risk of misusing the legal powers that the parties possess. The purpose of exercising legal power by the investment parties at this stage is to reach their interests. The investors have private interests and the states have public interests. The protective rights of the investors and the regulatory power of states are the paradigms of the private and public interests of the investment parties respectively. The conflict of interests between the parties can lead to an actual conflict, which might be referred to arbitration for resolution.

In the arbitration phase, the powers of arbitrators interfere and the two dimensional relationship converts to a three dimensional network of power. In this phase the arbitrators play a crucial role, as they have the legal power and the authority for decision-making. The arbitrators are conferred power from different sources. As arbitration is a consensual form of dispute resolution, the conflicting parties can decide on the scope of the arbitrators' power. However, the law, as a further source of arbitrators' powers, fills the gap when the disputing parties fail to decide on some powers of arbitrators. Furthermore, the law decides the mandatory powers of the arbitrators. Apart from the parties and the law, arbitrators have inherent power. Inherent powers are those powers that flow from the judicial nature of arbitrators' functions.

By the powers that they gain from various sources, arbitrators can play significant roles with respect to the substantive and procedural aspects of the conflict. The role of arbitrators with respect to the substantive aspect of conflict is related to powers of the parties in the bargaining and performance of investment. In that regard they can balance the inequality of bargaining power through their own source of power and on the basis of the doctrine of

inequality of bargaining power. As for powers of the parties in the performance phase and the role of arbitrators with regard to that, the principle of proportionality justifies the exercise of power by arbitrators in order to balance the interests and consequently the powers of the conflicting parties.

From a procedural perspective, for the sake of legitimacy, arbitrators' powers should be exercised by considering the principles of the rule of law. Thus arbitrators ought to consider the equality before the law, they must be impartial and independent, and decide on the basis of the principle of procedural justice.

Having considered the substantive and procedural roles of arbitrators – which are exercised through their own power base – the consequences of the interaction of the powers of the players was then explored under the title of power and the law. The focal argument of this research is based on the fact that the supremacy of the legal power of arbitrators is contingent on substantive and procedural requirements, all of which constitute the rule of law. The procedural pillar of the rule of law, which consists of principles of equality before the law, impartiality and independence, and procedural justice lead to the legitimacy of the investment arbitration; and the substantive pillar of the rule of law, which consists of the balancing of the inequality of bargaining power and balancing the public and private interests of the investment parties, enhances the effectiveness of investment arbitration. However, effectiveness and legitimacy are interconnected and one may lead to the other.

Therefore, in this sense the rule of law, as the supremacy of the legal power of arbitrators over the political and economic power of the conflicting parties, is a source that would first of all confer legitimacy on the investment arbitration system and secondly increase the effectiveness of that. Legitimacy is the belief that investment arbitration is based on principles of the rule of law. Effectiveness is the extent to which the investment arbitration

system satisfies the basic functions of conflict resolution, which entails the balancing of power and interests of the conflicting parties. The importance of legitimacy and effectiveness for the investment arbitration system is that they respectively lead to sustainability and development of the investment arbitration and international investment system.

FINDINGS. The following conclusions can be drawn from the present study. One of the findings to emerge from this thesis is that arbitrators, like investors and host states, possess power. Thus investment arbitration is a three dimensional relationship of three forms of power: legal, economic and political.

A further major finding is that in order to increase the sustainability and development of the investment arbitration system, its legitimacy and effectiveness needs to be enhanced. Arbitrators as power holders in the investment arbitration relationship can play an essential role in this respect.

The findings of this research suggest that arbitrators in investment conflicts must, in addition to the principles of the rule of law – including equality before the law, impartiality and independence, and procedural justice – balance the power and interests of the parties. Therefore investment arbitrators shall balance the inequalities of power, as well as the public interests of host states with private interests of investors.

SIGNIFICANCE OF THE FINDINGS: The current findings add substantially to our understanding of the importance of power in foreign investment. The issue of power in investor-state arbitration has a great impact on the fundamental aspects of the foreign investment system. Yet, despite its importance, power has not been at the centre of attention in the investment literature. The analysis of power in investment has been from two perspectives. On one side of the spectrum, it has been claimed that investors and particularly MNEs wield power over host states and that the system is a new form of colonialism. On the

other side of the spectrum, the argument is in favour of the investors, and it emphasises the fact that investors are private parties that need protection against the sovereign powers of host states. These arguments on power in the investor-state relationship have led to controversies on the role of arbitration with respect to power. Some believe that investor-state arbitration is a tool for powerful investors to exert power in the resolution phase. On the other hand, opponents believe that arbitration has not been effective in considering imbalance in the investment relationship and seek to redress it in favour of the investors, as the weaker parties. Consequently, the argument about power in international investment has been a two dimensional, limited to the above-mentioned challenges. There has not been an in depth and expansive analysis of power in respect to its origin, its character, and its effects on the investment system.

The findings from this study make several contributions to the current literature. This study considered power in investment arbitration as a three dimensional relationship of three forms of power: economic power of investors, political power of states, and legal power of arbitrators. The findings can be used in implementing investment regulations, BITs and investment contracts. More importantly, the results of this research on the importance of power in investment arbitration can be considered by arbitrators in their decision-making.

LIMITIATION OF THE CURRENT STUDY: A number of important limitations need to be considered. Firstly, the current study was not specifically designed to evaluate the factor of power in empirical case study. Conversely, the thesis is based on a theoretical analysis of the problematics of investment arbitration. The reasoning behind that is the scarcity of an in-depth analysis in this field, which underpins the solution to problems. As the focus of this research is on power, and as power is the most important but at the same time the least visible element, it is not easy to explore investment arbitration cases based on this factor.

Secondly, the aim of the thesis, as the first theoretical account of the role of power in investment arbitration, was to only underline the role of power as a neglected factor in this field. Future research should therefore concentrate on the in-depth empirical analysis of power in investment arbitration.

RECOMMENDATION FOR FURTHER RESEARCH: The findings of this study have a number of important implications for future practice, and this research will serve as a base for future studies. As both investment arbitration and the concern of power in this field are new subjects, there are therefore many gaps that must be filled by future studies. Thus, as the final point of this thesis, it is essential to address recommendations for supplementing this theme in the form of suggestions for future research. These recommendations can be classified into two clusters of theoretical and practical works.

On a practical level, examination of power in investment arbitration cases through empirical examples is the task that I suggest for further research. There is, therefore, a definite need for finding pertinent indicators to measure power in practice.

On a theoretical level, it is recommended that further research be undertaken in the following areas: the need for *control systems* and *a global governance role for investment arbitrators*.

The former is concerned with the nature of conferment of power. In one view, arbitrators must be conferred unlimited powers in order to enhance the effectiveness of arbitration. In the other view, it is necessary to control arbitrators' powers to protect the parties from any misuse of power on behalf of the arbitrators (Blackaby, et al. 2009, 314) and the conferment of power should be accompanied by a control system. To put this another way arbitrators are delegated power in order to exercise their functions. To guarantee that arbitrators function properly within the scope defined by the law, and therefore guarantee the

objective of the arbitration mechanism, there should be a system of control. “Controls are techniques or mechanisms in engineered artefacts, whether physical or social, whose function is to ensure that an artefact works the way it was designed to work” (M. Reisman 1992, 1). The purpose of the control system is to optimise the operation of dispute resolution systems. “In social and legal arrangements in which a limited power is delegated, control systems are essential; without them the putative restrictions disappear and the limited power may become absolute” (M. Reisman 1992, 1). Thus, without a control system, arbitrators may exceed their delegated powers and this results in reducing the effectiveness and legitimacy of the arbitration system.

The system for the protection of the disputing parties against excesses on the part of arbitral tribunals is usually contained in a framework for recourse against the award itself. However, some national laws also permit a level of control imposed more directly upon individual arbitrators. Thus, arbitrators might be removed for certain types of wrongful conduct. This might be done under the rules of an arbitral institution, where applicable (in some circumstances) under the law governing the arbitration agreement or, more usually, under the law governing the arbitration itself, by an application to the courts of the country in which the arbitration takes place (Blackaby, et al. 2009, 314). The control on the individual arbitrators increases their accountability and thus it can be concluded that accountability is a mechanism of a control system.

A further mechanism of a control system is the establishment of an appeal body in investment arbitration (Sauvant 2008). Indeed the lack of a body of appeal in investment arbitration has led to inconsistent and incoherent awards, and as a result of that the legitimacy of the system has been affected. Thus the possibility of appealing in investment conflicts is a subject that merits further study.

The second recommendation for optimising the international investment system, which deserves in-depth research and analysis, is the global governance role of the arbitrators (Kingsbury and Schill 2009). Primarily the function of arbitrators is to settle individual conflicts between parties; additionally they act as global governors to structure the global administrative law. Arbitrators interpret BITs, they set standards and principles that may be used as precedents in future disputes, and they assess the actions of host states – such as the regulatory power for public interest of the country – vis-à-vis private interests of investors – such as fair and equitable treatment. Therefore arbitrators' decisions not only affect the direct disputing parties, but the host state's nation(Kingsbury and Schill 2009).

The public function of investment arbitration underpins the core theoretical analysis of this field and entails further investigations. Although there has been a growing literature in regard to the practical and private functions of arbitrators in resolving disputes, the public aspect and theoretical studies of this field are at primitive stages. Only recently, due to the increase in investment arbitration and the emergence of critical challenges to this field, such as legitimacy and effectiveness, there has been a tendency to approach its public function through theoretical analysis in order to deal with these challenges. Thus the challenging argument that needs to be explored by future research – and which has its roots in the issue of power as examined in this thesis – is whether arbitration possesses the legitimacy to play a global governance role in the international investment law system and more generally international law.

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